

Financial Sector Development

A report by a Sida task force

June 1997

Department for Infrastructure and
Economic Cooperation

FINANCIAL SECTOR DEVELOPMENT

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“The biggest difference between rich and poor countries is the efficiency with which they use their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency (WDR 1989)”

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EXECUTIVE SUMMARY

Evidence from the performance of developing countries seems to indicate that a well-functioning financial system is an important element for achieving sustainable growth. The existence of an efficient and secure financial market can, in combination with appropriate economic policies, contribute to raising the total savings in the economy. Moreover, an efficient financial market channels the savings into productive investments, thereby improving the efficiency of the capital stock in the economy. In recent years, the following trends seem to have further enhanced the function of efficient financial systems in developing countries as a tool to improve growth prospects:

- The implementation of structural reforms and the increased recognition by policy makers of the importance to improve conditions for domestic resource mobilisation;
- The decline in the inflow of official development funds;
- The increase in private capital inflows (both portfolio and direct investments);
- The increased efforts to reduce outflows of flight capital and to stimulate the return of such capital;
- The increased demand for capital from the domestic private sector;
- The enhanced efforts to restructure and privatise state-owned commercial ventures;
- The increased capital requirements for infrastructure projects;
- The increased need to restructure social security systems;
- The increased efforts to broaden the ownership of assets and to allow for less privileged groups to benefit from economic growth;
- The deregulation and global integration of financial markets;
- The rapid development of information technology facilitating the integration of these markets.

As a follow up to the merger in 1995 of five Swedish development co-operation agencies, Sida was mandated by the Swedish government to review its policy in relation to the mobilisation of financial resources in developing countries, focusing on countries in Eastern and Southern Africa. The Review should include recommendations regarding the promotion of domestic resource mobilisation as well as regarding measures to stimulate inflows of foreign private capital.

The Review was conducted by a Sida task force on Financial Sector Development (headed by Lars Ekengren, Deputy Director General of Sida). A reference group which included experts from different areas of the Swedish financial sector provided valuable support to the task force. In the course of the review the task force commissioned six special studies covering (1) Swedish aid in the financial sector, (2) resource mobilisation in Sub-Saharan Africa, (3) financial systems in Africa including some comparisons with the systems of East Asian countries, (4) the informal finance sector in developing countries, (5) foreign direct investment and other private capital flows to Sub-Saharan Africa and (6) the effects of equity investments for capital market development.

Evaluations show that the overall lasting impact on the development of a viable financial system was rather limited of Swedish financial sector assistance in the 1970s and the 1980s. Macroeconomic imbalances, extensive involvement of the public sector in financial intermediation as well as distorted markets for goods, capital and foreign exchange were considered to be the main factors behind this rather disappointing result.

From the early 1990s, measures to tackle the macro-economic imbalances and financial system reform became integral parts of the Structural Adjustment Programmes implemented in most of the countries receiving Swedish aid funds. As a consequence, the experience of financial sector aid projects carried out by SIDA, BITS and SwedeCorp in the 1990s appears to be more encouraging than in the previous decades.

Nevertheless, in most countries in Sub-Saharan Africa the deficiencies of domestic financial systems yet constitute major obstacles to economic development and poverty reduction. With the exception of South Africa and Zimbabwe, the financial systems are shallow, narrow and undiversified. There are various factors contributing to this unsatisfactory situation:

- the low income of households and the low profitability of most economic undertakings
- the history of financial repression and governmental interference in the financial system
- the instability of the macro-financial environment and lack of steadiness of macro-economic policies
- the lack of appropriate legal, regulatory and prudential frameworks
- the highly fragmented markets and the low degree of interaction between the formal and the informal market segments
- the scarcity of technical and managerial financial skills

Moreover, the mismanagement of the public finances has also contributed. The large budget deficits absorbed a substantial part of the limited financial resources in the economies. As a result, credit to the private sector was “crowded out”. In many East Asian economies, by contrast, governments have been net savers during certain periods. Publicly owned banks in Africa have often been instructed to finance primarily the public sector, including loss-making parastatals. Their East Asian counterparts have financed primarily the export industry. Furthermore the Sub-Saharan countries have been much less successful than the countries of East Asia to increase savings through the growth of pension funds, insurance companies and other non-bank financial institutions.

Private capital now accounts for more than 80 per cent of net long-term flows to developing countries, totalling USD 285 billion in 1996. These flows are spreading also to low-income countries. For example, private capital flows to Sub-Saharan Africa, while still only around 10 USD billion, are now several times greater than they were at the beginning of the 1990s. In addition to recorded capital inflows, there have been substantial private transfers by individuals to countries in this region. A large portion of these flows are believed to be related to returning flight capital. It can be argued that the increase in foreign direct investments and other private foreign capital flows to Sub-Saharan Africa is important in relation to the limited private domestic investments taking place. Moreover, even small capital inflows may have important demonstration effects on domestic and other foreign investors. These private flows could be crucial for the future growth potential of the region, especially when official development assistance is on the decline, both in absolute and relative terms.

Political instability, debt overhang, inadequate institutional framework, deficient financial systems, low levels of education and skills, small markets and low reliance on privatisation are some of the factors that are holding back foreign private capital flows to this region.

The proposed Sida policy on Financial Sector Development aims at contributing to the fulfilment of the overall development goal adopted by the Swedish Parliament - to improve the quality of life of poor people - and the six subsidiary goals of economic growth, socio-economic equality, economic and political independence, democratic development, sustainable use of natural resources and gender equality. Financial sector development is particularly related to the promotion of economic growth but may also contribute to meeting the other goals.

The main responsibility for the development of the financial sector rests with the government in the recipient countries and the various private actors. The role of Sida is to support the efforts of these parties. Sida, apart from providing finance for such efforts, has an important role in the elaboration of financial sector policies in recipient countries and in the design and implementation of assistance projects. Sida may also act as a catalyst for the mobilisation of additional resources for project purposes and as a networking agent for contacts with other foreign partners so as to enhance co-ordination and stimulate transfer of know-how.

In addition to basic assistance related to the promotion of peace, democracy and human rights, Sida's efforts to promote good governance (the rule of law, good public sector management and the fight against corruption), macro-economic stability, financial market safety nets and a competitive environment are essential prerequisites of successful financial sector assistance.

The merger of the five Swedish development agencies has improved the possibilities to provide efficient financial sector development assistance. While the old agencies often made interventions at one level of the sector (macro, meso or micro), Sida may combine interventions at different levels at the same time. In this respect, Sida may employ a variety of aid instruments and has the advantage of cooperating with both government and non-government parties, potentially benefitting from synergies with Sida support to other sectors.

The goal of Sida's financial sector assistance is to contribute to the provision of efficient, sustainable and competitive financial services to the benefit of governments, enterprises, households and individuals.

The recommendations of the Review can be summarised as follows:

It is proposed that Sida should provide technical assistance for the development of (1) a basic legal and regulatory framework, (2) financial markets and financial institutions and (3) a capacity to prevent and monitor crises in the financial sector. Sida should also provide financial assistance (i.e. provision of capital) which may take different forms depending on the conditions for the transfer. Loans and guarantees could be provided directly by Sida. The availability and the specific features of these instruments will depend on the decisions taken by the Swedish Government in relation to the recommendations by the Concessionary Credit Study ("kreditutredningen"). Provision of risk capital should normally be made through other agencies such as Swedfund which may act as shareholders and execute owner functions in the financial institutions. Sida should only provide refinancing of such risk capital on the condition that Sida does not take the full risk.

Sida's country strategies should provide the basic guidelines as to the type of development projects. In a limited number of countries, e.g. countries in Eastern and Southern Africa, a

proactive approach should be applied. Priority should be given to creating an enabling environment for the actors of the sector.

When support is provided to commercially oriented non-government projects efforts should be made not to distort the competition in the sector. Other criteria for selection of projects will be: (1) catalytic effects, (2) innovation and demonstration effects, (3) areas where there are "gaps" in the provision of services to target groups favoured by Sida, (4) commitment, experience and managerial capacities of the owners of the financial institutions, (5) degree of cost sharing, (6) possibility to promote organisational solutions which are sustainable from managerial and financial points of view and (7) possibilities to involve the Swedish resource base.

Assistance in the field of microfinance will be of importance in Sida's future work towards poverty reduction, rural development and microenterprise development and should form a substantial part of Sida's poverty-oriented programmes in Eastern and Southern Africa. In order to back up such an approach efforts should be made to mobilise the Swedish NGO sector.

Chapter 10 has been prepared with the purpose of being a self-contained document providing information of the proposed Sida policy on financial sector development.

1. BACKGROUND

1.1 Mandate and terms of reference

As a follow up to the merger in 1995 of five Swedish development cooperation agencies, Sida was mandated by the Swedish government to review its policy in relation to the mobilisation of financial resources in developing countries. The Review would include recommendations regarding the promotion of domestic resource mobilisation as well as foreign private capital flows.

The Sida Management Committee agreed, at a meeting on 17 September 1996, on the following terms of reference for the Review:

- a) The Review should focus on the development of countries in Eastern and Southern Africa.
- b) The Review should take into consideration the findings and recommendations of two previous studies on related issues; Sida's aid reviews with regard to Concessionary Credits ("Kreditutredningen") and Private Sector Development ("Näringslivsöversynen").
- c) The Review should describe and analyse the financial sector assistance which has been provided by SIDA BITS, SAREC and SwedeCorp prior to mid-1995 and by "new Sida" thereafter.
- c) The Review should analyse the mobilisation of financial resources in a few countries in Sub-Saharan Africa.
- d) The Review should discuss the factors that are impeding an increased mobilisation of financial resources (domestic resources and foreign private flows) and analyse which kind of technical assistance projects may be used to overcome these obstacles.
- e) The Review should discuss the role of financial assistance (loans, guarantees and provision of equity capital) in the promotion of efficient and sustainable financial institutions in developing countries.
- f) The Review should discuss the role of Swedish institutions in financial sector development.
- g) The Review should discuss the possibility to achieve synergy effects in Sida's financial sector development projects through: 1) enhanced cooperation with foreign development cooperation partners; and 2) improved coordination within Sida.
- h) The Review should present a policy for financial sector development. It should also elaborate on organisational aspects and the staffing required for implementing the policy.

1.2 Implementation of the Review

The Review was conducted by the Sida Department for Infrastructure and Economic Cooperation (INEC), headed by Lars Ekengren, Deputy Director General of Sida. In the beginning of October 1996, a working group was formed, consisting of Lars Ekengren, Mikael Söderbäck, Jan Grafström, Jan Engström (secretary) - all from Sida INEC - and Lars Johansson of Sida Department for Policy and Legal Services.

In addition, a reference group was formed consisting of Claes Norgren (Swedish Finance Supervisory Authority), Leif Vindevåg (Stockholm Stock Exchange), Enrique Rodriguez (SWEDBANK), Irja Hedin (Föreningsbanken), Prudence Woodford-Berger (Stockholm University), Olle Arefalk (Swedfund International AB), Lars Kalderén (consultant), Rune Barnéus (consultant), Jan Bjerninger (Ministry of Foreign Affairs), Gösta Edgren (Sida Department for Policy and Legal Services), Peeter Horm (Sida Department for Central and Eastern Europe), Mario Zejan (Sida Department for Research Cooperation), Per Lundell (Sida Department for Democracy and Social Development) and Lars Liljeson (Sida INEC). The reference group provided valuable support and advice to the working group. The reference group convened on four occasions between 8 October 1996 and 25 March 1997. At the meeting on 28 November 1996, Mr Noritaka Akamatsu of the Financial Sector Development Department of the World Bank was invited to present his views on securities market development in developing countries.

In the course of the review, INEC commissioned a number of special studies which are form appendices to this report.

1.3 Disposition of the report

The report is structured as follows: Chapter 2 deals with assistance for financial sector development against the background of the Swedish development objectives. Chapters 3 and 4 of the report deal with general aspects of savings, investment, growth and the role of the financial system in the development process. The analysis contained in these chapters are based on studies presented by Lisa Román and Bo Karlström. Chapter 5 deals with the experience of Swedish aid in the financial sector and is based on a study by Karlis Goppers. Chapter 6 on regional and global trends is based on a study prepared by Jan Engström when working as a national expert for the European Commission. Chapter 7 focuses on the development of the financial sector in Eastern and Southern Africa. The chapter is mainly based on four diagnostic financial sector studies carried out by Lisa Román, Bo Karlström, Lars-Erik Birgegård and Gunnar Fors. Chapter 8 deals with the feasibility of using Swedish technical resources for development assistance work. Chapter 9, based on a study by Björn Mothander, elaborates on Sida's involvement in the provision of capital resources to financial institutions. Finally, Chapter 10 presents a proposal for a Sida policy in this field.

2. FINANCIAL SECTOR DEVELOPMENT IN THE LIGHT OF THE SWEDISH DEVELOPMENT OBJECTIVES

The overall objective of Swedish development assistance is *to improve the livelihoods of the poor*. In the Government's 1995 instruction to Sida, the overall objective of poverty reduction was further underlined and Sida was mandated to focus on long run poverty

reduction. To this end, Sida has developed a special Action Programme which aims at improving the living conditions of the poor. In the Action Programme, the important link between economic growth and sustainable livelihoods of the poor is emphasised. It is important that the assistance to financial sector development projects is analysed in this context. Obviously, financial sector development projects are usually not directly geared towards the poorest strata of the population. However, as will be shown in the forthcoming analysis, well-functioning and efficient financial markets are instrumental in order to achieve sustainable growth. Against this background, it appears that financial sector development projects generally contribute to alleviating the living conditions for the poor, at least in a longer perspective.

It should, nevertheless, be underlined that economic growth is not a sufficient condition for the poor to become better off. A fair distribution of income and wealth is also required in order to make progress in the fight against poverty. In this respect, it is important to create more jobs and ensure improved opportunities for peasants and self-employed. Here, financial sector development projects geared directly towards the poor population can be very useful. Giving access to sustainable systems for provision of microfinance and opportunities for small savings can be of vital importance for directly improving the living conditions of the poor. Experience from such microfinance schemes in various countries shows that also the very poor are "bankable". These encouraging experiences explain the special attention given in this report to the role of microfinance and the services of the informal financial sector.

Equality between women and men is a specific dimension of the struggle against poverty. Sida has also established an Action Programme for Promoting Equality Between Women and Men. In this Action Programme, three main structural and systemic causes of gender inequality are identified. One of these is the disparities in "equal participation in economic decision-making and economic independence". This is certainly true for access to financial services. Formal and informal constraints often exclude women from such services. Apart from being a violation of women's human rights, it is also economically inefficient. Experience from microfinance projects has shown that women generally are more reliable when it comes to taking care of an economic activity and repaying loans. Excluding women from financial services imply that a number of viable economic activities would not be realised despite their pay off. As a consequence job opportunities and income generation are not realised.

The link between financial sector development and the objective *to defend human rights and democracy* is less clear. However, it follows from this objective that equal opportunities to financial services, such as access to credits, should be ensured in the development process. Hence, no groups or individuals should be excluded from access to financial services owing to their gender, ethnic belonging, religion, etc.

Similarly, the link between financial sector development and the objectives to ensure a *sustainable development* is rather remote. Financial sector development is in itself unlikely to affect the environment. To the extent that financial sector development leads to increased investment activity, a case could be made that it might bring about more stress on the environment. In this respect, it should be made clear that the composition of investment which is relevant rather than the absolute investment level. The investment composition is determined by the relative prices on products and inputs as well as by the knowledge about, and access to, modern production techniques. These factors can largely be affected by responsible government policies, outside the scope of the financial

markets. Of course, financial market development projects could in principle be used to obtain similar results, for example through the earmarking of credit funds for environmentally sustainable technologies. However, from an efficiency point of view, it is generally more efficient to give direct subsidies to the preferred products/production methods and to avoid direct subsidy interventions in the financial markets.

Environmental concerns are particularly low when working with institutional development of the financial sector per se. However, when the financial sector is used as a means to channel financial support to projects, the case is somewhat different. Sida is subject to far-reaching scrutiny by the public on the use of Swedish aid funds. Thus, in the case of on-lending of aid funds, the environmental effects of the projects for which the funds are ultimately used need to be assessed.

Finally, it is interesting to note that in all Sida Action Programmes as well as in this report on financial sector development, *good governance* and an appropriate institutional framework are emphasised as essential preconditions.

3. SAVINGS, INVESTMENT AND GROWTH

To save is to sacrifice current consumption for the future. In the national accounting system, savings are defined as the residual when the value of the total production is reduced by the value of total consumption. The savings rate, i.e. gross national savings as a share of GDP, has fallen world-wide since the 1970s, although there is considerable variation between countries. When analysing the economic performance of developing countries in recent decades, an apparent empirical relationship emerges: economies showing high real growth rates usually also have high rates of savings and investment. Nevertheless, it is not necessarily the case that high savings is a prerequisite for investment, in turn causing high growth. It may be that there are other features of an economy that promote growth, which in turn encourage further savings and investment. It may be that other features drive savings, investment *and* growth.

3.1 Growth and investment

A cherished view among development economists ever since the 1940s has been that growth is best promoted by increasing investment, i.e. physical capital accumulation (the Harrod-Domar model). The approach may be labeled capital fundamentalism, and has been a guiding principle for a substantial share of development policies. In contrast, traditional neoclassical theory assigns a very limited role to capital accumulation, and thus the savings rate (the Solow-Swan model). A more recent theoretical development is the so called endogenous growth school which assumes, briefly, that technological change is determined by research and development activities. An implication of these newer theories is that investments in physical or *human* capital indeed may raise the rate of growth. In certain respects this is the return of capital fundamentalism.

Nevertheless, the causality between investment and growth remains unsettled. Recent empirical findings suggest a reverse causality: economic growth starts accelerating before investment ratios start to increase. Other studies examine the relationship between growth and investment in more detail, investigating the *kind* of investments which seems to go

along with growth. This approach highlights the importance of the quality of investments, not just the investment rate as such. Some empirical findings suggest that investments in equipment (machinery) are more important for growth than so called structural investment. In fact, some low-quality investment might waste resources in the economy and, thereby, be detrimental to growth in the long run although temporarily boosting the growth rate. The risk that such investments are undertaken is higher in economies with large distortions in the working of market forces, e.g. high barriers to market competition or foreign trade, price distortions, administrative investment regulations or skewed credit schemes. Another line of research suggests that public investment may be instrumental for growth, although the type of public investment is of importance (infrastructure investments may be growth promoting, while investments in state industry are not necessarily so).

The discussion leads to a complex picture of the investment and growth relationship. Technological change, and not physical capital accumulation *per se*, seems to be a crucial ingredient in the growth process. The technological change factor depends to a large extent on factors such as human capital investments, innovation climate, and entrepreneurship. The driving forces behind these qualities of economic life are found in *the institutional framework* of an economy, i.e. the rules, formal (laws) and informal (norms and conventions), constraining economic action. A general requirement for economic activity is clear and stable rules of the game. These include transparent and enforceable legislation, and limited risks of unpredictable changes in enterprise conditions. Well-defined and enforceable property rights may reduce the risk of expropriation (either through nationalisation or heavy taxation), a risk which most likely has a very negative impact on entrepreneurs' willingness to invest. Another particular growth promoting institution is a framework for efficient intermediation of financial resources, since a major obstacle to the entrepreneurs' ability to realize their ideas, is lack of capital.

3.2 Investment and savings

In a closed economy, national savings and domestic investments are equal by definition. In a fully open economy, i.e. an economy where capital can flow freely, across the borders, the expected rates of return internationally will determine where people's savings are placed. In view of the substantial reduction in barriers to capital flows in recent decades, it can be expected that the correlation between savings and investments within countries has been reduced. This notion is challenged by empirical findings, and to some extent also theoretically. The correlation between domestic savings and investments, despite capital mobility, have been shown to be very strong in a large number of countries (the Feldstein-Horioka puzzle). The most straight-forward explanation is to claim that capital is not as mobile as believed for various reasons (political risk, currency premiums, "home-country bias", etc). Another type of explanation turns on *domestic* capital immobility: firms' and households' tendency to finance investments from their own savings.

Indeed, a very large proportion of all investments made, in particular in developing countries, are self-financed. Firms and households retain a substantial share of their profits/surpluses and invest them in their own businesses. Self-financing may be beneficial for the firm or the household: it internalizes information and incentives, which may substantially reduce a number of transaction costs. The drawback of self-finance is that it may not provide sufficient resources to fully realize the investment opportunities. There is, thus, a role for the financial system to reallocate resources from savers to investors.

3.3 Driving forces behind savings

Whereas there is a positive correlation between the income level of a country and the savings rate, at least up to a certain level of income, there is no clear evidence that the income distribution of a country affects the savings rate. Possibly this may be because saving is driven by many different motives, which may affect different groups of the population in various ways, depending on the specific conditions in each country.

People save for several reasons. First, there is the *income smoothing motive*. According to the permanent income hypothesis, the consumer distinguishes between permanent and temporary income, and will save temporary income increases (or dissave - i.e. borrow or use up the savings in case of temporary income reductions) so that consumption remains equal to the individual's permanent income. Also, people behave differently over their life-cycle: dissaving when young, saving in mid-life and again dissaving during retirement. These hypotheses may explain how saving adapts to a given income stream, but they have difficulties, among other things, in explaining the positive correlation between savings and growth.

Another reason for saving is the *precautionary motive*. The individual may save for "the rainy day": if unemployment strikes, if the harvest goes bad, if the children will not provide for you as old. Precautionary saving depends on the individual's opportunity to insure himself. In the developed world, there are formal insurance companies as well as social transfer systems which reduce uncertainties about future income. In developing countries, a substitute may be the extended family, which may guarantee that the individual will be provided for in case of health problems, old age or bad luck, thus reducing this savings motive.

Partly related to both of these two arguments is the *bequest motive*: people save for the future generation. Some empirical studies suggest that bequests are more important for the wealthy than the poor. Bequests may still be important in developing countries, and among poor, for example manifested in keeping the small farm within the family (and not sell it off at old age, as suggested by the life-cycle hypothesis). It should be noted that a bequest may not only be a sign of altruism, but may also be control motivated (the bequestor makes sure he is able to influence decisions until his death), or have a precautionary motive.

In conjunction with these arguments, *demography* obviously affects aggregate saving, although relationships are ambiguous. High fertility rates may have a negative effect on saving, if people have many children as a substitute for saving for their old age. Reductions in mortality rates may have a positive effect on saving, because investments in education are more profitable (people live longer). Moreover, a growing population may mean a growing labor force which causes growing incomes and growing savings. On the other hand, there is a fairly robust *negative* relationship between dependency ratios (the proportion of young *and* old people to the number of people active on the labor market) and savings rates.

Another category of savings motives are *sociological*. For example, consumption habits may lag behind income changes. This explanation would fit empirical findings of the savings and growth correlation. Urbanisation may also affect savings, although it is unclear in what direction. On the one hand, urban life may bring more investment opportunities,

thus encouraging savings. On the other hand, urban life style may encourage increased consumption.

A final factor encouraging or discouraging savings behaviour is the *access to credit*. The permanent-income and life-cycle theories assume that there are no borrowing constraints. However, most developing countries are characterised by rather fragmented capital markets, where individuals for various reasons may be restricted from borrowing, both for consumption and investment purposes. Thus, there is reason for the individual to save in order to make an investment, be it in a physical asset or, for example, in education.

3.4 Savings and the financial system

Savings may be held as financial assets (e.g. money and bank deposits) or real assets (e.g. houses, machines, food supplies). The ratio of financial assets to GDP is an indicator of financial depth, measuring the magnitude of monetisation and financial intermediation. The financial system is deeper in richer countries than in poorer ones. Financial deepening is not in itself a sign that savings are increasing, only that the savings are becoming more and more formal. A formal financial system may, however, allocate savings to more productive investments.

For a long time, the general truth in development economics was that a low savings potential inhibits poor countries from accumulating resources and initiating economic growth. Thus the poor countries could not rely on mobilising domestic resources. Most of the domestic savings were involuntary mobilised through taxation, inflation, and overvalued exchange rates. Paradoxically, at the same time as there was a well established belief that capital accumulation, and thus the savings rate, was important for economic growth, the possibility to mobilise these savings through the financial system was ignored. To some extent, this may have been because the governments of developing countries were motivated to mobilise resources provided by foreign aid donors. Similarly, donors may have had vested interests in providing large volumes of financial aid, rather than encouraging the countries to rely on domestic savings mobilisation.

The neglect of savings mobilisation was also related to the generally negative view on finance; finance was believed to squeeze the real sector for resources, and accordingly had to be controlled. This resulted in policies of financial repression, including legislation on interest rate ceilings, and programs of subsidised credit. This trend was reversed in the recent decade. Repressed financial markets have since the early 1970s been seen as an important reason behind slow economic development, since they limit incentives for financial accumulation, and contribute to maintaining inefficiencies in the banking sector. While the causality between financial deepening and growth remains unsettled, it is clear that there is a positive correlation between the two. One hypothesis is that banks may effect entrepreneurial activity not only by the provision of finance, but also by their competence in selecting and monitoring projects.

In situations where financial markets are subject to interest rate control, a liberalisation leading to higher real interest rates is generally associated with increases in savings, investments and growth rates. The effect of the interest rate level on savings is ambiguous. For net savers, high real interest rates encourage savings (the substitution effect) as well as consumption (the income effect). Conversely, for net borrowers, the effects go in the opposite direction. High real interest rates also stimulate people to keep their savings in

financial rather than real assets. Hence, higher real interest rates causing financial deepening imply that more resources are intermediated to investments. Moreover, this credit may be allocated to more productive investments through the lending competence in the formal banking system.

In addition to this argument for financial liberalisation, evidence points to that subsidised credit schemes often involve important drawbacks. Such schemes normally rely on an administrative rationing of credit, implying an inefficient allocation of resources. In addition, any rationing situation invites corrupt behavior by bank and government officials.

In many countries, financial liberalisation shows that the savings potential in developing countries has previously been underutilised. In fact, even very poor households often manage to save.

Nevertheless, the unconditional praise of financial liberalisation has been modified in the last few years. For one thing, the positive association between real interest rates and growth may be an indication of more stable macro-economic conditions, rather than the level of interest rates themselves. Today, there is an emphasis on sequencing liberalisation, carefully considering the general economic conditions at hand. The actual effects of financial liberalisation have been very different across regions. Financial liberalisation does not always mean that credit is allocated efficiently. Poor information systems and weak enforcement mechanisms may motivate banks to exercise inefficient credit limits even under liberalised conditions.

If formal financial institutions are suppressed or under excessive control, various forms of *informal* finance are there to replace them. In many ways informal finance is an efficient response to various transaction costs, but may fail in the agglomeration function that formal banks perform. Once again, the institutional setting determine the possibilities for efficient economic performance.

4.THE FINANCIAL SYSTEM IN THE DEVELOPMENT PROCESS

4.1 Financial markets and institutions in the development process

As referred to in the previous chapter, a well-functioning financial system is important for achieving sustainable growth. The existence of an efficient and credible financial market can, in combination with appropriate economic policies, contribute to raising the total savings in an economy. Even more importantly, an efficient financial market channels the savings into productive investments, thereby improving the efficiency of the stock of capital. An efficient capital stock generates more production and thus higher incomes -- in short it promotes higher standards of living. Therefore, the development of financial markets is a key to economic progress.

As an economy develops, the financial system "deepens". This means two things: First, the volume of financial transactions grows more rapidly than GDP, meaning for instance that the stock of money in relation to GDP increases; second, that the average maturity of financial contracts increases due to a shift from cash to bank deposits and to longer-term claims such as pension rights, bonds etc.

Informal financial systems are common in the early stages of development. They are characterised by regional or ethnic kinship, often specialising in certain types of lending (e.g. small scale agriculture), absence of formal collateral, high risks and thus relatively high interest rates.

Commercial banks dominate the formal systems in most developing countries, often accounting for 70-80 per cent of the transaction volume of the formal financial sector. In many developing countries, market concentration is high with one or a few commercial banks dominating the banking system.

During the past few decades, small domestic banks and similar financial institutions have been established in most developing countries. These small banks are often financially weak. The combination of a few (often state owned) large banks and a number of small and weak private institutions has, in many cases, led to inefficient financial intermediation and a high degree of instability in the systems.

Savings and loan associations play an important role in the financial markets of some developing countries. Together with the commercial banks, they provide a branch network. However, in many countries, the branch networks are insufficient for the operation of intra-regional transfers. This often constitutes an obstacle to the integration of rural areas into the monetary economy.

As an economy grows and per capita incomes rise, new forms of financial transactions develop. Leasing companies and venture capital companies provide finance with varying degrees of risk for entrepreneurs in the private sector. Government borrowing tends to move away from the central bank and commercial banks (which is inflationary) towards financing through securities markets (see Section 4.2 below). In some developing countries, this development has provided for the establishment of long-term capital markets, where also private bonds and shares are traded. Stock exchanges are being developed in most African countries, but so far they have only played a minor role in the financial systems.

Various kinds of institutions absorbing long-term savings and providing loans with long maturities constitute the institutional backbone of the capital market. In addition to stock exchanges, housing finance institutions, insurance companies and pension funds (public and private) are important actors in the capital markets.

4.2 The government and the financial system

Experience from financial sector development has contributed to a growing consensus that the government should avoid to directly intervene in the financial intermediation process. The government nevertheless plays an important role in promoting well functioning financial systems. First, the government plays a crucial role for establishing the policy environment and providing the regulatory framework. In this respect, three different elements can be distinguished:

- The government's general **fiscal and structural policies** form the basic framework within which financial markets and institutions function.

- The central bank is responsible for the conduct of **monetary policy**, i.e. the central bank influences the liquidity situation in the economy with the aim of controlling inflationary developments. The central bank can act through short-term lending to the banking system and/or by requiring financial institutions to maintain reserves with the central bank. The central bank may also have the function of lender-of-last resort for the banking system.
- The government has an essential role in providing the **legal and regulatory systems** surrounding banking and other financial activities. In this field, banking supervision is particularly important in order to maintaining the savers' confidence in the banking system.

Second, the government has also important roles as client and promotor for the financial sector. The governments are important users of the payment systems and they also use the financial system as a source of funding for their current and capital spending. In industrial countries, government deficits are mainly financed by selling securities to the public. However, in most developing countries, deficits are yet financed by borrowing from the banking system. In some developing countries, more than half of domestic bank credit is used for financing the public deficit. To the extent that the credit is provided by the central bank, such policy leads to increased inflationary pressures in the economy. Government borrowing from the domestic commercial banking system, e.g. through the imposition of high reserve requirements on banks, is less inflationary but leads to reduced profitability in the banking sector, distorted interest rates and crowding out of private investment. In order to enable the government to finance itself through the securities markets rather than through bank credits, it is important to develop domestic financial structures and markets. In this respect, the central bank has an important task in establishing a market-oriented monetary policy framework, organising and overseeing the domestic payment and securities settlement systems, and developing the money market. Thus, the central bank needs to work actively with the banking system and market makers in establishing appropriate market codes, building up confidence among investors for the available market instruments. Experience shows that once efficient money markets have been established, they can play a significant role in the mobilisation of domestic credit also for private borrowers.

5. SWEDISH AID IN THE FINANCIAL SECTOR

5.1 General overview

Over the years Swedish aid agencies have engaged in a large number of aid projects geared towards some aspects of financial sector development.

In a survey report (Appendix 1) commissioned by the Financial Sector Aid Review Committee financial sector support by Swedish aid agencies, both to developing countries and to transition economies, was categorised and accounted for. The financial sector development projects were grouped in five main categories:

- I General projects and sector programmes containing a credit facility or other "financial components"
- II Financial sector projects: Mainly provision of credit or equity
- III Financial sector projects: Mainly technical assistance and training
- IV Grants for financial sector research
- V Financial market reform supported by balance-of-payments aid

The criterion used for defining a financial sector project was whether it contains an explicit element of *institution building* with respect to the development and the functioning of the country's financial infrastructure.

The survey, which should be considered tentative as the data still contain uncertainties, concluded that Swedish aid agencies have spent approximately 3 billion SEK on almost 250 projects related to financial sector development (Table 1):

Table 1: Swedish support to financial sector development projects (1965 - 1996)

Type of aid	"Old" SIDA	BITS	SwedeCorp	Swedfund	SAREC	"new" Sida	Others	Total
I. Projects and sector programmes containing a credit component	24 projects 668 MSEK						2 projects 141 MSEK	26 projects 809 MSEK
II. Financial sector projects - provision of credit lines or equity	14 projects 747 MSEK	8 projects 420 MSEK	13 projects 138 MSEK	11 projects 118 MSEK		7 projects 188 MSEK		53 projects 1611 MSEK
III. Financial sector projects - technical assistance and training	14 projects 146 MSEK	21 projects 176 MSEK	4 projects 8 MSEK	3 projects 4 MSEK		6 projects 13 MSEK	70 projects 20 MSEK	118 projects 367 MSEK
IV. Financial sector research					51 projects 4 MSEK			51 projects 4 MSEK
Total	52 projects 1561 MSEK	29 projects 596 MSEK	17 projects 146 MSEK	14 projects 122 MSEK	51 projects 4 MSEK	13 projects 201 MSEK	72 projects 161 MSEK	248 projects 2791 MSEK

Credit components were present as an integral part of larger development projects and programmes already in the 1970s, particularly in the rural development programmes. Evaluations show that the lasting impact of these early credit schemes on the development of a viable financial system was rather limited. Even though the donor agencies have become increasingly aware of what was needed in order to build a sustainable financial system, the general economic environment has not been conducive to mobilising financial savings at the micro level. In particular, the extensive involvement of the public sector in production as well as financial intermediation, often in a monopoly situation, and distorted markets for goods, capital and foreign exchange has hampered the development of a sustainable financial system.

A typical example of this disappointing outcome is the *small scale industry project in Tanzania*. Despite a relatively high nominal repayment rate of the credits extended, the

project basically functioned as a system to distribute subsidies involving little or no real local resource mobilisation.

Such a negative outcome is in fact the general pattern for many comparable SIDA programmes in the 1980s, for instance the *Sweden Zambia Industrial Co-operation programme*. An evaluation found this project unsuccessful partly due to the fact that the project was largely implemented during the peak of a chaotic macro-economic situation in Zambia when firms were faced with an extremely unfavourable economic environment.

Agriculture and rural development is the sector where SIDA had the most projects with a financial component. In the 1990s, a new generation of rural programmes appeared with a more focused and demanding financial component. Examples are the revolving credit funds linked to several forestry development programmes and village banks. These latter programmes should be assessed against the background of a macroeconomic environment in the 1990s which is more conducive to the development of financial systems as compared to the heavily distorted macro-economic environment prevailing in most recipient countries in the 1980s.

The importance of the macroeconomic environment was emphasised in a Nordic working group memorandum on rural finance prepared in 1993. In the memorandum, it was stated that unfavourable macro-economic and sector policies, reliance on easily accessible government and donor funds rather than savings deposits, subsidised lending interest rates, etc have resulted in poor performance and collapse of many formal rural financial institutions." Of particular concern was that few credit programmes and few formal financial institutions have proven to be relevant for poor people and especially for women.

5.2 Financial sector projects: provision of credits or equity

Since the mid 1970 **SIDA** has cooperated with some government-owned development banks, providing them with both credits and rather extensive technical assistance. The main thrust of this support was the provision of credits to priority investments, rather than the development of the financial system as such. The general and consistent picture which emerges from evaluations of these programmes is negative. Operating in economies with heavily distorted prices both in the product and capital markets, these public investment banks were primarily used to provide inefficient state companies with loans that were rarely repaid. Many of these state companies had, in fact, no potential to become self-sustained.

The oldest of these projects, dating back to 1967, is the support to the *East African Development Bank (EADB)*. SIDA provided development credits to a total amount of MSEK 190 to EADB. Although the EADB always served the Swedish development credits on time, various evaluations over the years pointed to that the institution suffered from serious problems. For a long time, the EADB suffered from insufficient solidity and liquidity, lack of own and external capital, a loan portfolio in acute need of rehabilitation, as well as management problems. However, in an assessment in 1994, SwedeCorp found that subsequent efforts to rehabilitate the EADB's loan portfolio had been successful. Recently, the EADB has successfully raised its first loan in the capital market.

SIDA gave a total of MSEK 250 over 15 years to the *Tanzania Investment Bank*. In practice, the main function of the bank was to channel large amounts of foreign exchange to unproductive parastatal companies which rarely repaid their loans. The Bank has been evaluated several times with progressively more negative findings.

The *Central American Bank for Economic Integration* (CABEI), received MSEK 60 in grants with the purpose of channelling credits to small enterprises. Evaluations have found that CABEI encountered serious problems given its traditional emphasis on (political) development goals, and that it would have to be restructured if it is to play a major role in servicing the private sector with investment capital.

An internationally famous bank, which has received almost MSEK 300 in support from Sweden is the Bangladeshi *Grameen Bank*. This Bank started in 1976 as an experiment in lending to the poor and to women. The Bank explicitly stated the goal to show that poor people are able to accumulate savings and that they are able to manage repayment of credits in a disciplined way. Although recent evaluations have warned against actual and potential problems ahead for the Bank's continued financial viability, SIDA's involvement in the Grameen Bank must overall be labelled a success. It was catalytic in the sense that SIDA was one of the first to support it, thereby attracting other donors. Today Sida's aid has been discontinued, and for a very gratifying reason, namely that, in the words of the responsible programme officers, "it is no longer needed".

A new generation of credit programmes in SIDA's aid portfolio were the ones directed towards housing construction and microcredits for the urban poor. The first of these programmes were started in Costa Rica and Chile in 1987. Later similar programmes in Nicaragua and Salvador were supported. Presently, a further housing credit programme in South Africa is under negotiation. In total, approximately MSEK 200 have been granted to social housing projects, mainly as revolving credit funds, but also for technical assistance. The *catalytic* effect of these programmes is much emphasised, consisting mainly of luring the regular banking sector into the financing of poor peoples' housing.

The largest of these programmes was the support to housing in slum areas in Costa Rica, *FUPROVI*, which with regard to financial strategy has two objectives: to reach the poor and to achieve long term sustainability of the institution itself. An evaluation found the project to have succeeded well regarding both objectives. The self-help construction programme as well as *FUPROVI* as an institution provide a model to be studied and applied elsewhere.

SIDA provided MSEK 48 to the *Local Development Programme* in Nicaragua, *PRODEL*. In 1996 an evaluation of this project turned out to be generally positive: "Amidst extremely difficult conditions PRODEL has created innovative working institutional arrangements which contribute to the development of local and municipal capabilities".

Between 1988 and 1993, **BITS** granted eight concessional credits, totalling approximately MSEK 800, to national development banks in India, Thailand, Pakistan, Chile, Tunisia and Malaysia. BITS worked exclusively with already well established, and solid banks. The objective was thus *not* to contribute to building up the financial systems, but rather to use existing banks as reliable *conduits* for channelling credits to industry.

Box 1. Swedish support to the banking sector in the Baltic states

In the course of 1994 BITS conducted a comprehensive study on how to promote the banking sector of the three Baltic states. On the basis of this study the Swedish government in September 1995 allocated MSEK 240 for a project to be implemented by a subsidiary company of Swedfund International AB, Swedfund Financial Markets (SFM). A major share of the funds will be used for risk capital investments in private commercial banks in Estonia, Latvia and Lithuania. Some funds will also be used for technical assistance to such banks. The SFM investments are made in close co-operation and consultation with the World Bank Financial Institutions Development Programme the main purpose of which is to improve the financial intermediation capacity of the banking sector in the Baltic states. Often investments are made in parallel to investments by EBRD and Swedfund's sister organisations in Europe. By March 1997 SFM has invested a total of MSEK 161 in nine commercial banks, three in Estonia, three in Latvia and three in Lithuania. SFM is also a shareholder in the three national investment banks. In addition to financial and technical assistance provided by SFM technical assistance is provided by Sida (Department for Central and Eastern Europe) to the financial sector in the Baltic states. Sida's support is focused on training programmes and training institutions in e.g. banking and insurance as well as to the development of laws, regulations and central supervisory institutions and systems for the financial markets. Sida i.a. provides support to the central project implementation units that have been established in the finance ministries to supervise the World Bank/SFM Support Programme.

Perhaps the most active of the Swedish aid agencies in providing aid geared towards financial sector development was **SwedeCorp**. By 1994 it had developed a dozen projects, most of them investments in credit lines or equity. SwedeCorp's mode of work was "from down up", meaning that most of the projects came about as a result of initial discussions with entrepreneurs at firm level. The SwedeCorp projects were started as late as 1994-95, which means that there are no ex post evaluations available as yet.

According to a broad definition of *financial sector aid* projects, **Swedfund** is involved in 11 such projects. In addition it has in its books five equity investment projects financed by a *conditional* loan from SwedeCorp. All of the Swedfund investments were made in the last two years and no evaluation has yet been carried out. The experience reported informally is positive so far.

Since "new" **Sida** was created in 1995 with the merger of SIDA, BITS and Swedecorp, a new generation of more focused capital market development projects have seen the light. Among the ones consisting mainly in the provision of capital is the capitalisation of FNI, a refinancing institution in Nicaragua (Box 2), a regional risk capital fund in Central America, CAIF, as well as an environmental risk capital fund in Central America. None of these projects has yet been evaluated.

Box 2. Restructuring of a state-owned financial institution in Nicaragua

Between 1987 and 1995 about MSEK 150 were allocated as SIDA support to the government of Nicaragua for the promotion of non-traditional exports. These funds were channelled to the banking system through a public entity, *Financiera Nicaraguense de Inversiones (FNI)*, which was controlled by the central bank. As a follow up of an appraisal of this support Sida decided in 1996 to condition further support to the export programme to an operational and financial restructuring of FNI. As a first step Sida provided consultancy support for FNI to prepare a plan of operation regarding its future role as a commercially oriented second tier bank, i.e. a capital market institution that would refinance and guarantee loans provided by the commercial banks to producers of non-traditional export goods. As a second step Sida reached an agreement in principle with the ministry of finance of Nicaragua regarding the use of MSEK 50 as an additional financial assistance by Sweden. This agreement included terms (commercial rates of interest) for onlending to FNI and conditions related to the conversion of loans to equity and the composition of the new board of FNI. In the fall of 1996 the government of Nicaragua initiated its work to restructure FNI financially, i.e. bad loans were removed from the balance sheet of FNI. Following the approval by parliament of a new law (expected by mid-1997) which will turn FNI into a banking corporation partly open to private shareholders Sida will start its disbursement of funds to FNI. This project may be seen as an example of a synergy of traditional Sida aid and capital market development which is geared towards achieving a sustainable institution operating on market terms.

5.3 Financial sector projects: technical assistance

The list of financial sector development aid from **SIDA** contains a dozen projects, of which half are only a few years old. In the 1960s, there were a few technical assistance projects in connection with the privatisation of the banking sector in Tanzania, but also in Kenya and Zambia. The largest of these projects, MSEK 55 in support of the establishment of the Central Bank of Namibia, was started in 1990 (Box 3). Then followed computerisation in the Central Banks of Kenya and Tanzania, debt management in the Ministry of Finance in Kenya, support to bank inspection in Zambia, and budget support to debt and foreign exchange reserve management through *ESAIDARM*. The second largest project - general technical assistance and training for the banking sector in Vietnam - started in 1992.

So far only a few of these projects have been evaluated. An evaluation of the *savings promotion programme* in 1993 came to negative conclusions, whereas SIDA's support to the debt management project to Kenya and the support to the Central bank in Lesotho were found to be successful. An evaluation in 1994 of the very large support - MSEK 60 - to the Vietnam banking sector was somewhat critical, also regarding some aspects of the implementation by the donor SIDA.

Box 3. SIDA support for the establishment of the Bank of Namibia

Between 1990 and 1995 about MSEK 55 were disbursed by SIDA for the Bank of Namibia project. The main objectives of the project were 1) to assist the government to establish a fully-fledged, self-sufficient and well-functioning central bank and 2) to contribute to the financing of the country's own currency. Of the funds about 1/3 were used for services and equipment in relation to the currency objective, 1/3 were used to establish the computer system of the bank and 1/3 were used for technical assistance and training of the other functions of the bank. The project was carried out in close collaboration with the IMF. Sweden provided the bank with a deputy governor (who was later nominated Governor), a training co-ordinator, an advisor on currency transactions and bank operations and a manager of the bank supervision department. According to an independent evaluation in 1995 the project has to a major extent fulfilled the mission of providing Namibia with a well-functioning central bank. At the macro-level this implies the leadership as regards monetary and foreign exchange policy and management. At the meso level this implies inter alia the ability to take the lead as the supervisor of the banking sector. At the micro level this implies to perform as an efficient organisation. By mid-1994 all major functions were held by Namibian staff members. As to the future, the evaluators recommended that the bank should improve its central bank competence in areas such as financial supervision, financial research and the development of money and capital markets.

BITS' technical assistance related to the financial sector in developing countries consisted mainly of the financing of studies and evaluations by the International Development Banks through *Swedish Consultancy Trust Funds*. Moreover, BITS provided substantial technical assistance to the financial sector in Eastern and Central Europe. Between 1992 and 1995, about 35 different projects were supported with a total amount of MSEK 50. For the next fiscal year, 15 new commitments at a total cost of MSEK 23 are planned in Eastern and Central Europe.

The main emphasis of BITS technical assistance to Eastern and Central Europe has been on training in the banking and insurance sector in the Baltic States, Poland and Russia. In Poland, a total of MSEK 10 was granted for education and training in banking and finance. The programme was deemed successful in a recent evaluation, evidenced by the fact that 90 per cent of the people trained regularly used their newly acquired knowledge in their work. A similar programme in Russia was also found to have been successful, although the evaluators recommended important changes to be made in case of future support.

In the field of *cadastral and mapping* support, which can be a powerful tool or prerequisite for developing financial markets, BITS has financed large programmes in the Baltic States and in Russia. Altogether more than MSEK 80 have been spent on these projects since 1989. These projects have recently been evaluated in four separate evaluations - one for each country - resulting in overall positive assessments.

"New" **Sida** has so far initiated half a dozen technical assistance projects in the financial sector. Two of these projects are related to the building up of capital market authorities cum securities exchanges in Cap Verde and Tanzania. One project in Zambia supports the local stock exchange, and another in Zimbabwe supports the management function of a venture capital fund. See also Box 4 regarding the reform of the legal framework for securities markets in Bolivia.

Box 4. Reform of legal framework for securities markets in Bolivia

Capital market promotion was selected as one of the key areas for Swedish support when SwedeCorp initiated its private sector development programme in Bolivia in 1994. An outdated and inefficient legal system governing the issue and trading of corporate securities was identified as a major obstacle for the promotion of securities markets in Bolivia. Following a request from Bolivia's parliamentary committee on economic development Sida decided in 1995 to provide technical assistance for the reform of the corporate elements of a revised securities market law. A team of experts presented a draft proposal for such law at a Sida sponsored capital market conference in Bolivia in the beginning of 1996. As a follow-up on these discussions the experts drafted a new proposal that was handed over by Sida to the parliamentary committee in mid-1996. A final version of the new law is expected to be approved by parliament by mid-1997.

Perhaps the most sustained effort of technical assistance in the financial sector by a Swedish agency is the work done by the **Swedish Finance Ministry** in Russia. Between 1992 and 1996, some 70 different technical assistance projects (including seminars and training visits) were implemented at a total cost of over MSEK 20. Of these projects, 21 have been specifically geared towards public debt management and financial markets. A recent evaluation carried out of this programme criticised *parts* of the programme (not however the financial markets projects) for lacking in efficiency and focus.

5.4 Grants for financial sector research

Of the funds that were allocated by SAREC to *economic* research in the Third World, some were used for research on *financial sector* related issues. Among the receivers of these funds is the African Economic Research Consortium (AERC). AERC is considered to be a highly successful forum for economic research and debate. Of a total of 238 research stipends distributed by AERC, 41 were in support of studies on financial markets and private savings and investment.

SAREC has also extended substantial grants to development research at Swedish institutions, but the prevalence of research on financial matters has been very modest. Of the MSEK 372 granted over 20 years, only MSEK 1.7 were spent on research related to financial sector development. Judging by the *number of* studies the picture is even less encouraging, as only 10 out of perhaps 1000 studies have dealt with the financial sector.

5.5 Financial market reform supported by balance-of-payments aid

If balance-of-payments support or debt relief is conditioned upon the successful implementation of various elements of financial market reform, then most observers would agree that this type of support *can* be a powerful means of achieving financial sector reform. In some cases it has been shown that a premature liberalisation of financial markets, before the budget deficit has been brought under control, has led to very high real interest rates and speculation, and therefore in effect harmed the development of financial markets. This however does not change the overall contention made in the survey report of Swedish financial sector aid, namely that:

structural adjustment, including macro-economic stabilisation and abolition of the grave distortions previously existing in the markets of goods, capital, labour as well as foreign exchange, is a *necessary* condition for developing a sustainable financial structure”

From the early 1990s it became increasingly common to find indicators pertaining specifically to the banking and financial sectors among the targets and the conditions posed in connection with structural adjustment lending. This was also the time when Swedish aid policy started adhering more closely to the IMF's judgement of when a programme was "on track" or not. It might therefore be argued that in terms of supporting the introduction of financial sector reforms, Sweden's balance of payment support during most of the 1990s - amounting to about MSEK 1000 per year - has been a relevant instrument.

Box 5. Financial System Reform and Structural Adjustment in Nicaragua

Reform of the financial system played a central role in the programs aimed to stabilize the economy at the beginning of the Camorro administration. The modernization and reform of the financial sector was a key element in the program agreed with the International Financial Institutions in 1993, which led to the first ESAF. Today, Nicaragua is quite advanced in this reform and modernization effort. This effort had three main orientations. First, the program focused on modernization and reform of the Central Bank. A new law was introduced enhancing its role in monetary policy, eliminating its commercial operations, and increasing its degree of independence. Simultaneously, an effort was made to increase the technical capability of the Bank. Second, the banking sector was opened to private initiative. Several private banks opened, both with foreign and domestic capital, but also with repatriated Nicaraguan capital. By 1996 there were about a dozen private financial institutions in the market. These private banks captured rapidly a large share of deposits. The expansion has been slower in the loans market, but already private banks have a majority share of the market. Finally, the state has had a process of divestment in the banking sector, closing some state-owned banks and strongly reducing and reforming others. This process is still going on in spite of facing serious political problems. The introduction of some important institutions also contributed much to this process. One of them is the "Superintendencia de Bancos" controlling prudential regulations and publishing an important flow of data, which contributes much to the transparency of the system. Another institution is Managua's Stocks and Values Exchange, the first such institution in the Central American region. Sweden cooperated from the beginning to this development, indirectly through its financial support to the Structural Adjustment Program, and directly, through its support to the FNI, a second tier investment bank, and by supporting training and education programs within the Central Bank.

6. GLOBAL FINANCIAL SECTOR TRENDS

6.1 Structural reforms and the overall need to increase savings

The urgency for achieving a broad based sustainable economic development (with increased real per capita incomes) in developing countries point to a need to mobilise savings to productive investments in these countries. Most developing countries are in a process of reforming their economies by introducing basic market mechanisms, improving fiscal and monetary control, liberalising regulatory regimes and restructuring the bank sector to allow commercial lending criteria and market interest rates to prevail. Following the restructuring of central banks there is a need for these countries to develop their financial markets. The "first generation" structural adjustment measures have paved the way for the introduction of reforms in the financial sector.

6.2 Increased demand for capital from the private sector

The efforts of developing countries to improve the environment for private sector development and to open up their economies for local entrepreneurs and local investors have created an increased demand for financial sector reforms. Several private sector assessment studies confirm that the dearth of long-term finance (including risk capital¹) for investment purposes is a major obstacle for the growth of the trade and industry sectors in these countries.

6.3 Restructuring and privatisation of public enterprises

The experience from some developing countries shows that privatisation of state-owned enterprises has served as an impetus for governments to speed up financial sector reforms. The redefined role of the state (to be less involved in the production and distribution of goods and services and rather focusing on supervising the market mechanisms and stimulating a healthy competition in the private sector) as well as the need to reduce the fiscal drain of public enterprises have been the major forces behind the efforts to privatise such firms. Particularly in Eastern and Southern Africa, these efforts have met with a number of obstacles. One hurdle is inefficient capital markets. Only a limited number of countries in this region have developed proper stock exchanges or contractual savings institutions, which could facilitate for local private investors to raise the capital needed to acquire state-owned enterprises.

6.4 The global race for foreign direct investments

The globalisation of trade and financial flows is presently transforming the world economy. This process is driven by several factors, such as the liberalisation of trade and capital markets, increasing internationalisation of corporate production and distribution strategies, and technological change that is fast eroding barriers to tradability of goods and services and the mobility of capital. In the coming ten years world trade is projected to grow by 6 per cent. Developing countries are a driving force in this process of change. Their GDP growth is expected to be around 5 per cent per year as compared to less than 3 per cent in the developed countries.

Annual average net long-term private capital flows to developing countries have increased from around USD 35 billion in the mid-1980s to almost USD 200 billion in the 1994-96 period. This increase of private capital flows contrasts with the decreasing flow of official development finance (presently around USD 50 billion per year).

About half of the net private capital flow is accounted for by foreign direct investments (FDI). It is true that a large share of these funds is concentrated to a limited number of countries in Asia and Latin America but the number of recipient countries is growing each year. The total value of FDI flows to Sub-Saharan Africa increased from less than one billion dollars in 1990 to around three billion dollars in 1996.

FDI flows tend to go to countries which can offer a stable and transparent economic environment. A functioning capital market is one important sign of such an environment.

¹ In this report interpreted as equity capital and loans in different forms which are not fully secured

Such markets also offer domestic possibilities to raise capital also for projects initiated by foreign investors.

6.5 Portfolio investors in developed countries

Portfolio investors in developed countries are increasingly attracted to capital markets in developing countries. As shown in section 7.5 the net portfolio equity flows to developing countries have increased from almost nil in the 1980s to around USD 35 billion annually in the last three years. Portfolio managers have realised that investing in "emerging markets" offer prospects for increased capital gains at reduced risks. African stocks have also attracted foreign portfolio investors. In 1994 more than USD 450 million (half of this in South Africa) were invested in the African stock markets.

The trend towards increased diversification of investor portfolios is likely to continue. The share of developing countries securities in investor portfolios of developed countries can be expected to at least double in the next ten years from the present level of about 1 per cent. According to one estimate, 40-45 per cent of the world stock market capitalisation in 2010 will be domiciled in developing countries (compared to about 15 per cent in 1994). In the same period, the share of African stocks in the emerging market portfolios is expected to increase from 1.9 per cent to 3.2 per cent (Barings Securities 1994). See also box 7 regarding growth of private pension funds in OECD countries.

6.6 Capital requirements for infrastructure projects

The last few years have seen an unprecedented world-wide increase in private participation in infrastructure financing. Provision of efficient infrastructure services, encompassing not only telecommunications and energy but also services related to transports are now widely recognised as indispensable to economic progress. The upsurge of interest in private financing of infrastructure has come from several sources. In many countries, governments and consumers have become disenchanted with the poor performance of publicly-owned infrastructure enterprises which provide infrastructure services. Constraints on traditional sources of finance for publicly-owned infrastructure enterprises have encouraged some governments to turn to private financing. Technological changes have also been important: telecommunications, power and transport systems are being "unbundled", generating competition in service provision which has reduced unit costs and facilitated private entry.

Developments in financial markets, and innovations in financial products such as Build Operate and Transfer, have enabled sponsors of private infrastructure projects to draw on a wider pool of financiers and financing techniques. According to estimates by the International Finance Corporation (IFC) the annual capital requirements for investments in infrastructure facilities in developing countries may exceed USD 200 billion per year in the coming ten years.

6.7 Need to restructure social security systems

In the 1970s and 1980s a substantial number of public pension plans (often of the pay-as-you-go type) in developed as well as developing countries experienced marked difficulties. Some developing countries, e. g. in Latin America, have been forerunners when it comes to reforming their pension fund schemes. Chile started already in 1981 with the introduction of decentralised private pension plans. The experience from Chile shows that there are possibilities to create a *dynamic interaction* between pension funds and capital markets. Chilean pension funds have had an impact on the quality of savings of the country, mainly by increasing the ratio of long-term savings in relation to overall savings. The fund managers have stimulated the introduction of new financial instruments in the capital market, some of which have resulted in substantial reductions in the cost of capital for the corporate sector. The funds have facilitated the privatisation of state-owned enterprises. They have also contributed to the introduction of improved stock exchange routines and improved accounting and auditing standards. Finally, the funds have stimulated the growth of small and medium enterprises in Chile through investments in venture capital schemes.

6.8 Other factors

Another positive experience from Latin America is that financial sector development - along with an overall improvement in the business climate - has contributed to the *return of flight capital*. In the case of Argentina, it is estimated that over half of the private capital inflow in the 1990s originates from such sources. This factor could be important also for African countries, in view of the considerable funds that residents keep abroad. Even if only a small portion, e. g. 8-10 per cent of the USD 100-150 billion believed to be kept abroad by Africans, would be invested annually in new industrial ventures in the countries of origin, such investments would be much higher than current FDI inflows and would have a substantial impact in terms of increased production, exports and job opportunities.

Moreover, experience shows that the introduction of new standardised and dependable capital market instruments - be it in public debt papers such as bonds or in corporate shares - stimulates the interests of individuals to save for future needs. Increased diversification tends to increase the productivity of capital which in turn gives an impetus for the common man to save and benefit from economic growth. In this sense, capital markets may help to engage new savers among the low income groups and become a *measure for spreading ownership of assets* and reducing economic inequalities in developing countries.

7. FINANCIAL SECTOR DEVELOPMENT IN AFRICA

7.1 Mobilisation of financial resources in Sub-Saharan Africa

Since the 1960s, the fall in growth and savings rates in Sub-Saharan Africa has been considerably more pronounced than the world-wide trend. The real growth rate per capita has averaged around 0.5 per cent annually. In the decade between the mid-1970s to the mid-1980s, real per capita GDP actually fell. Meanwhile, the average savings rate has fallen from some 12 per cent of GDP in the 1960s, to around 6 per cent in the early 1990s.

One reason behind this unfavorable development is the drop in world market prices for African export commodities. Another factor is that most of the sub-continent, after gaining independence from colonial powers in the 1960s, experienced a protracted period of devastating political turmoil. However, the overshadowing element was probably the unsuccessful macro-economic policies pursued in most countries. Existing growth-promoting structures were replaced by regulatory vacuums and/or economic systems which proved incapable to sustain efficient production. The unfavourable development was underpinned by interventionist government policies in industry and trade. In this respect, the focus on investment in publicly owned large-scale industry contributed to an inefficient allocation of resources and a bias against agricultural production. Mounting fiscal deficits, caused by lax expenditure control, limited tax revenues and generous government lending to the public sector, spurred inflation. Increasing poverty in turn reduced the scope for savings, while people lost confidence in existing formal institutions, notably the financial systems. The value of financial assets deteriorated when real interest rates were negative, while the banks' lack of competition discouraged their incentive to provide efficient financial services.

Many of the African economies are today struggling to recover and to restructure their economies. This process is demanding since a first requirement is to maintain tight fiscal discipline for the purpose of monetary stability. The restructuring programmes include liberalisation of trade and prices, and reform of the financial systems. However, it takes time to establish the suitable institutional framework, and to gain confidence in the process. Meanwhile, savers and investors hesitate to make use of the formal financial intermediaries. Informal financial solutions are yet important in many African countries and are likely to continue playing an important role.

These issues are explicitly brought forward in a study of the conditions for domestic resource mobilisation in four selected Sub-Saharan countries (Tanzania, Uganda, Zambia and Ghana). This study indicates that the domestic resource mobilisation still suffers from deficiencies in the institutional structure; deficiencies which are yet largely a reflection of the interventionist policies pursued in the 1970s and 1980s.

In order to assess the scope for assistance in the area of financial sector development, it is vital to have a notion of why the savings rates in these countries remain so low. Part of the explanation may be found in the macro-economic development. However, micro-economic factors need also be studied in order to achieve a better understanding of the driving forces behind savings behaviour of individuals.

As outlined in Section 3.3, several factors appear to be important when determining the savings behaviour of individuals, such as level of wealth, current and expected income, age, health situation, family structure, cultural and sociological factors. Against this background, it is likely that donors could help to improve the mobilisation of domestic savings through a large range of general measures, such as improving the educational systems. However, in order to give more clear-cut guidance, it appears more appropriate to confine the discussion to assistance geared at improving the institutional structure of the financial sector. In this respect, there seem to be mainly three areas where donors can usefully contribute to financial sector development: 1) assistance in the development of the general legal framework; 2) assistance in establishing an adequate tax system; and 3) assistance in the promotion of a functional financial system. Focusing on the latter, some general guidance can be given on the basis of donors' previous experience of assistance in this field.

A first lesson is that subsidies, e.g. in the form of interest rate ceilings, and other interventions in market forces are likely to be counterproductive. Subsidised interest rates lead to excess demand for funds, usually implying that the poorest are screened out of the market. In the same vein, subsidies or artificially high rewards for savings in the form of regulated high interest rates on bank deposits may have negative consequences in the long run. People are likely to respond to such interest rate incentives, inducing a portfolio shift in favour of financial savings in relation to savings in real assets. The total effect on aggregate savings is thus ambiguous. Moreover, a flawed interest rate structure may harm the sustainability and credibility of the banking system. In order to stimulate people to deposit their savings in banks and other formal financial organisations, it is more important to ensure that these are accessible, inspire confidence and are guided by relevant and reliable rules.

Another conclusion is that development banks and other government or aid financed funds often fail in repayment rates. A reason may be that these type of organisations are perceived more as providers of grants than of loans on strict terms and the borrowers are seen as beneficiaries rather than as bank clients. Another aspect of this problem is that the agencies themselves do not really have sufficient motivation to enforce loan contracts. The result may often be that the cheap money borrowed is wasted and the credit programmes are deemed a failure. In this context, it seems that credit projects which combine an element of savings mobilisation have a higher potential to succeed. Collective responsibility, implying that group pressure partly replace the need for physical collateral, can also be an important element for achieving a better outcome. One reason for this is that such programmes tend to internalise the resource mobilisation and create motivation among all the participating agents to see to the survival of the project. Such programmes also highlight the linkage between savings and credit facilities. Evidence suggests that savings are encouraged by the prospects of credit access in a not too distant future.

A final conclusion, following the above reasoning, is that assistance in this area should focus on various types of credit and savings organisations, for example by providing technical assistance or financing specific administrative expenditures. Since self-sustainability and adherence to market conditions seem to be vital for survival and expansion of various types of banking projects, it seems central that the donor support is conditioned on transparent and binding obligations on the part of the recipient.

7.2 Financial systems in Sub-Saharan Africa in a period of major reform

In most countries in Sub-Saharan Africa, the deficiencies of domestic financial systems constitute major obstacles to economic development and poverty reduction. Zimbabwe is the only obvious exception. Current efforts to stabilise and reform the financial sector in order to strengthen the legislation, regulation and supervision guiding banks and other financial institutions, are likely to have a substantial impact on the economic performance of the Sub-Saharan countries.

7.2.1 Commercial banks

In order to understand the financial systems in African countries, their problems and the role of foreign donor agencies, it is essential to focus on the banking systems, because of their central role as financial intermediaries. The commercial banks typically dominate the

financial scene in all developing countries, and perhaps more so in the countries in Africa, where they often account for about 70-80 per cent of total financial assets. All other parts of the financial systems are directly or indirectly linked to the commercial banking systems.

Banks are predominantly urban in their geographic locations and in their businesses. They traditionally provide finance for governments (often through regulations imposed by the authorities), for state-owned companies, and for established medium-size and large private enterprises. Their branch networks are often limited, and their supply of credit to small enterprises and small farmers is often negligible. In each individual country, one or two banks, often publicly-owned, have traditionally dominated the banking scene.

The commercial banking systems have been -- and still are -- fragile. Between 1988 and 1996, twenty African countries experienced systemic banking crises. In five of these cases, the costs of the crises exceeded ten per cent of GDP. In some countries, banks have been restructured. In others, the restructuring process is still incomplete. One indication, and often a crisis signal of potential bank failures, is the amount of non-performing loans in the banks' portfolios. The existence of large, publicly-owned banks with significant amounts of non-performing loans lies at the center of the financial problems in Africa and is a key to understanding the present problems.

Table 2. Market shares and bad debts of government-owned African commercial banks
(Estimates 1994-95¹)

	Share of market (%)	Bad loans (%)
Ghana (GCB)	50	70
Tanzania (NBC)	90	60-80
Uganda (UCB)	50	80
Zambia (ZNCB)	20	small
Mozambique (BCM)	80	45

¹Before placing non-performing assets into separate recovery trusts in Uganda, Mozambique and Tanzania.
Sources: Various World Bank documents (Financial Sector Reviews). In 1996-1997 some of these banks have been restructured.

The main factors behind the banking sector problems in the five countries studied (as well as in most other African countries) are surprisingly similar. They have to do with: a) poor economic policies; b) state ownership of banks and other corporate entities; c) lack of competence and experience in the financial field, and d) legislation, regulatory systems and supervision of financial activities.

a. Economic policies

Economic policies in most countries in Sub-Saharan Africa have been characterised by heavy state involvement and extensive regulation of interest rates and credit flows. This has destabilised the economies, weakened the financial systems, and inhibited an efficient allocation of national savings.

Governments have used the banking systems (both central banks and commercial banks) to finance budget deficits. The most common method has been prescribed asset (liquidity) ratios for the commercial banks. As a result, credit to the private sector has been crowded out. The most extreme example is Zambia, where the banks are required to hold 50 per cent of their assets as loans to the government.

b. State ownership and privatisation

The systemic problems in the banking sectors are intimately linked to the financing of weak, often insolvent, parastatal corporations. Banks have been instructed by governments to extend credit to such enterprises in order to finance not only their capital requirements but also, in many cases, their operating deficits. The banking sector problems are, thus, often a reflection of problems in the parastatal sectors. The financial sector reforms taking place in most African countries are therefore accompanied by privatisation programmes.

c. Lack of competence and experience

With state-owned banks playing an important role and with a variety of policy regulations related to bank credits and interest rates, there has been limited scope for developing indigenous financial competence in the private sector, for instance in risk evaluation of credits. Tanzania, where neither expatriate banks nor private domestic banks were allowed to operate until recently, is an extreme example. In most countries in Sub-Saharan Africa, the weaknesses in competence and experience in the banking sector are now being addressed, partly with the assistance of foreign donors.

d. Legislation and regulatory frameworks

As a result of the interventionist approach to monetary policy, the requirements of bank legislation, supervision and regulatory framework have been largely neglected. This has contributed to the fragility of the banking sectors in the countries in Sub-Saharan Africa. A legislative and regulatory framework is important in order to give investors confidence in the formal banking system, thereby promoting the domestic resource mobilisation.

7.2.2 Reform Programmes

As already mentioned, over the last decade, a number of countries in Sub-Saharan Africa have embarked on economic and financial reform programmes. These programmes generally involve liberalisation of credit and interest rate policies, privatisation of state owned banks, (e.g. in Mozambique, Tanzania and Uganda), enactment of new or improved bank legislation, and the establishment of supervisory and regulatory competence.

It usually takes some time before the benefits of reforms become evident. In fact, the measures undertaken may have adverse effects in the short run. In most cases, these adverse reactions are caused by lax fiscal policies and thus budgetary instability, leading to high rates of inflation (as experience from e.g. Tanzania and Zambia shows). Liberalisation of financial markets have also revealed the weaknesses in the regulatory systems. In some countries, reforms have been instituted too rapidly, before proper bank legislation and regulatory frameworks have been put in place.

A positive effect of liberalisation efforts is improved competition among banks and other financial institutions, and thus a more efficient intermediation and a lowering of transaction costs. Experience from other countries shows that, in the longer run, market oriented financial policies will impose a stricter discipline on government finances and a more efficient allocation of national savings. The latter effect is of great importance in promoting economic growth.

After nearly a decade of experience, there is a growing consensus that financial reforms in Sub-Saharan Africa require long periods of adjustment, particularly in the form of learning and institution building. The transfer of technical competence is, on the whole, more important than the transfer of funds for on-lending.

7.2.3 Capital markets and international capital flows

Capital markets, i.e. markets dealing in longer-term financial contracts, are emerging in most countries in Sub-Saharan Africa. This is a natural process as financial markets "deepen". The demand for longer-term finance by the private sectors, and the willingness on the part of governments to provide the legal and regulatory frameworks are fostering institutions and instruments in the capital markets. One impediment, common to most African countries, has been macro-economic instability, with large fiscal deficits and high rates of inflation. This often results in a crowding out of resources for private investment and creates uncertainty about long-term financial contracts.

Some forms of long-term finance have existed in most African countries for a number of years. Development Finance Institutions (DFIs) were established (with public funds) in almost all the countries in the 1960's in order for governments to provide finance for long-term development. As referred to in Section 5.2, these experiments were generally ill-fated, in many cases even detrimental to the development efforts. Lending was often based on other than commercial terms, the banks were underfunded etc. The DFIs are now being either reformed or closed. Other capital market institutions with a history in African economies include housing finance companies, insurance companies and pension funds (often state run). Many of these institutions have, like the DFIs, been insufficiently capitalised and subject to political interference. The financial reform programmes mentioned above usually involve also these institutions in the capital markets. Examples can be found for instance in Tanzania, Zambia, and Uganda, where capital markets are weak.

Most African countries have had some form of statutory pension arrangements. However, such funds have often been mismanaged and need to be brought under stricter legislation and control.

Recent years have seen the development in many African countries of securities markets and the establishment of stock exchanges. These developments are closely connected with the privatisation programmes which require large amounts of risk capital and efficient secondary markets in corporate assets (shares). Zimbabwe has a long tradition of stock exchange trading, and recent years have seen a rapid expansion of trading on the Zimbabwe Stock Exchange. The Ghana Stock Exchange, although quite recent in origin, has also grown rapidly in recent years. Zambia, Tanzania and Uganda are now also moving to establish stock exchanges.

Several investment funds focusing on African stock markets have been established over the past few years in Europe and North America. The amounts, although small so far, are increasing rapidly. This may indicate that inflows of foreign private capital can potentially play a more important role in Africa's development.

7.2.4 The role of the state in financial markets

In virtually all countries in Sub-Saharan Africa, the state has looked upon the financial sector as part of -- and an instrument in -- a centrally planned economic policy. Governments have assumed ownership of large banks, sometimes the whole financial system (e.g. Tanzania), and have directed credit flows to "priority" sectors, in particular to the public sector. This role is now being reassessed and most countries are in the process of reforming the financial sectors and policies.

The reform processes under way in most countries in Sub-Saharan Africa have revealed weaknesses in financial legislation, supervision of banks and other agents in the market, and in the regulatory competence and procedures. It is in these areas that governments have an important role to play, rather than in owning and operating financial institutions. This new role of the state in the financial field is being increasingly appreciated in African countries.

7.3 Financial systems and policies in Africa and East Asia: a comparison

In assessing the financial systems in Sub-Saharan Africa economies, their weaknesses and their need for support, it may be of interest to identify some of the differences between the financial systems and policies in Africa and those in the rapidly expanding economies in East Asia.

There are many reasons for the vastly differing economic records of the African and East Asian economies. They concern questions such as political stability, education (investment in human capital), savings and investment, the role of foreign trade (global integration), and the respective roles of the public and private sectors.

Some of these differences are illustrated in the following chart (called a "Development Diamond"), which measures four development indicators for Ghana, Thailand and Malaysia.

Chart 1.

.....
(Figure 1. Insert figure, blown up, from
Chhibber and Leechor, p 87)
.....

Source: A. Chhibber, Journal of Africa Economies - May 1995.

The impression gained from this picture, for instance the ranking order of the three countries, can be reinforced by looking at a number of other variables, such as income per capita, relative prevalence of poverty etc. Tanzania, Uganda, Zambia and other countries of interest in the Swedish aid context, would show a pattern similar to that of Ghana in this picture.

The focus here is on the financial aspects of development in Africa and East Asia. The financial systems in most countries in Sub-Saharan Africa have a number of characteristics in common. They are part and parcel of, and to some extent a cause of the stagnation in the African economies. By contrast, the East Asian economies have on the whole created financial environments which have been conducive to economic progress -- although there are substantial differences between the countries.

In Africa, as well as in East Asia, banks and other financial institutions operate in a policy environment which is largely determined by the countries' governments, including central banks and regulatory agencies. It may be useful to divide the "policy environment" into two spheres. One has to do with fiscal and monetary policies, including the modes of financing government deficits. These policies largely determine the growth and stability of the economy. The second sphere of the "policy environment" relates more specifically to the legislative and regulatory rules and frameworks surrounding the operations of financial institutions and markets.

The most notable differences between the financial systems in African and East Asian economies concern the first aspect of policies, i.e. those that define the macro-economic frameworks and, specifically, the degree of stability of the economies. Table 3 below illustrates some of the relevant differences in the "stability record" between Sub-Saharan African and East Asia.

**Table 3. Some macroeconomic indicators for Africa and East Asia
(1960-1992)**

	Budget balance ¹	Inflation rate ²	Black market exchange rate premium	Real interest rates ³
Africa (SSA)	-5.5	26.9	76.6	-67.0
East Asia	-1.8	16.4	7.6	+2.0

¹ Including foreign grants.

² GDP deflators.

³ Banks' deposit rates deflated by consumer price indices. Data cover only the period 1986-1993.

Main source: Collins and Bosworth, "Economic Growth in East Asia", in Brookings Papers on Economic Activity, 1996:2.

Source for real interest rates: IMF, Sub-Saharan Africa, Growth, Savings and Investment, 1986-93.

The effects of the macroeconomic and financial instability in African economies on financial markets have been compounded by some other features, common to most

countries in Sub-Saharan Africa. The prevalence of large budget deficits in African economies has led governments to absorb a major part of the limited financial resources in their economies to finance these public deficits. As a result, credit to the private sector has been "crowded out". In many East Asian economies, by contrast, governments have been net savers during certain periods; on average and for the region as a whole, the public sector deficits have been very modest, leaving large and increasing financial resources for the private sector. Chart 2, comparing the record of Ghana with that of Thailand illustrates this point.

Chart 2.

Figure 2 (from Chhibber, p 102)

Source: A. Chhibber, *Journal of Africa Economies* - May 1995

Publicly owned and run banks are common not only in Africa, but also in East Asia. The political intentions behind this have been largely similar in the two groups of countries, namely to exert control on the economy through the allocation of finance. In both groups, such banks have also been misused as a source of political funds and private wealth. Nevertheless, there are important differences. Publicly owned banks in Africa have been instructed to finance primarily the public sector, including loss-making parastatals; they have also been allowed to run large deficit for long periods. Their East Asian counterparts have financed primarily the export industry and have seldom been allowed to run deficits and, particularly, not to fail.

In both regions, there have been policies to limit new entrants into the financial sector. This, together with large state-run banks, has reduced competition. However, in the generally more competitive environment in East Asia, this has had less detrimental effects on transaction costs (spreads between lending and deposit rates) than in Africa.

In contrast to most African countries, East Asia has a long tradition of trade and finance, particularly as regards formal financial arrangements. As a result, experience and competence in arranging financial contracts is more deeply embedded in the East Asian culture than in the African. The prevalence in many East Asian countries of long-term financial arrangements, such as life insurance and pensions, may be seen as a result of

this tradition of financial contracts. Savings channelled through pension funds constitute a very substantial part of national savings in many East Asian countries. Such funds also form a stable backbone of the capital markets in these countries. In contrast, long-term contractual savings in the form of pensions and life insurances play only a marginal role in the African economies.

Although the financial systems in most East Asian economies are more advanced than those in Africa, the development of legal and regulatory frameworks of financial transactions is of rather recent origin in most East Asian countries. African countries, with only a brief financial history, have been even slower in creating legal and regulatory frameworks for the financial markets; this process has only begun in the last few years.

In summary, the most notable differences in the financial field between Africa and East Asian relate to macroeconomic stability and thus to the trust and confidence in formal financial institutions. This has implications for the degrees of monetisation and financial depth, for the provision of risk capital for the private sector, as well as for the division of credit between the public and private sectors. In other areas of policy, such as public ownership of banks and regulatory rules, the differences between the two groups are less marked.

The differences in financial developments between the two groups of countries is captured clearly in the measurement of financial depth, i.e. the ratio between money supply (broadly defined) and GDP, as illustrated in Table 4 below.

Table 4. Financial depth
(Broad money supply (M2) as a percentage of GDP)

	1980	1994
Ghana	16.2	15.8
Tanzania	na	30.7
Zambia	28.4	14.0
Zimbabwe	35.2	25.8
Uganda	12.7	9.8
Indonesia	13.2	41.0
Korea	29.0	40.6
Malaysia	46.1	83.9
Thailand	34.5	74.2

Source: World Bank, *World Economic Indicators*, 1996

The financial depth in the African countries is substantially lower than in the East Asian countries and has been stagnant (in some cases declining) since 1980. By contrast, the East Asian economies show rapidly increasing financial depths over the past decade and a half. One important reason for this development is the growth of non-bank financial institutions (pension funds, insurance companies, mutual funds etc) in East Asia.

In comparing the two regions and trying to draw lessons from East Asia for Africa, a further comment may be relevant. In the East Asian countries, capital markets, especially securities markets, were developed in the 1970s and 1980s, largely as a result of government promotion and intervention. There was a great deal of instability in these markets, particularly during the 1980s. A general lesson to be drawn from this experience is that governments promoted such markets prematurely, before setting up solid legislative and regulatory rules for transactions in these markets. The African economies, coming later into this phase of financial development, should learn from this experience and allow capital markets to grow primarily as a result of private sector demand for such services, and also to prepare the legal and regulatory framework at an early stage of this development.

Inflows of international capital, both foreign direct investment and portfolio investment, have played an important role in stimulating the development of the economies in East Asia. In Sub-Saharan Africa, such inflows have hardly begun. In searching for the reasons for the large capital flows into East Asia, the main explanations are to be found in a few factors: the relatively high degree of political stability, the macro-economic and financial stability record (as discussed above), and the rapid growth. In addition, external debt has on the whole not been a problem in the East Asian economies. On all these scores, the African scene has been less favourable.

In some countries in East Asia, capital inflows have been attracted also as a result of open policies for foreign capital, with only limited restrictions on capital movements. Among the less developed countries in the region Indonesia is the most extreme case, but Thailand and Malaysia also belong to this group (and, of course, Singapore and Hongkong). South Korea, on the other hand, has until very recently pursued a highly

protectionistic policy with respect to capital inflows. All the countries in Sub-Saharan Africa have had complicated foreign exchange restrictions, including complex rules for investment and ownership -- both direct and portfolio investment -- by foreigners. Although there is a tendency towards more liberal systems, several of the countries in the region still retain restrictive policies on cross border capital movements.

7.4 The informal finance sector in developing countries

7.4.1 The informal sector and rural credits

The informal finance sector is generally defined as that segment of the financial sector which is not controlled by financial legislation and central bank supervision. A sub-division of the informal sector alienating non-traditional actors (government projects, NGOs, etc.) to what is called the semi-formal sector is often made. This limits the informal sector to traditional or indigenous actors and institutions.

Although there are few quantitative analyses of the relative significance of the formal and the informal financial markets in developing countries, it is a general view that the informal market dominates over the formal market, particularly in rural areas, and particularly in Africa. Poorer sections of the populations, notably women, are almost exclusively dependent upon the informal market.

Financial markets in most developing countries are dualistic in nature with one formal and one informal segment. The linkages between the market segments are weak and the market is fragmented. Typical is also that even the informal segment is highly fragmented with a large number of actors on highly localised markets. Recent theoretical work and empirical evidence explain this fragmentation with structural characteristics of the market resulting in asymmetric information and differences in transaction costs thereby refuting the financial repression hypothesis.

Traditional actors in the informal financial sector include relatives and friends, professional money-lenders, landlords, traders and shop-keepers and credit and savings groups (notably ROSCAs).

A key characteristic of the informal financial markets is that they are demand driven as regards the needs and preferences of their clients. This implies that credits are often given on the following basis: no collateral requirements, no restriction on the use of credit, low transaction costs, flexible credit terms, quick processing of requests and no minimum credit amounts. Formal financial institutions on the other hand are generally characterised by the opposite on all this points.

The financial services provided on the informal markets are limited with emphasis on short-term credit. To what extent this reflects the structure of demand or a supply constraint is not very well known. The limited data available seems to suggest that savings and borrowing primarily is for short-term income smoothing and consumption rather than investment. While lending funds are largely mobilised on the informal markets, there is evidence that deposit services are inadequate.

The conventional wisdom is that interest rates on the informal markets are excessive. This seems however not fully substantiated. While the fragmentation of the market may well result in extraction of monopoly profits, a simple comparison of interest rates on

formal and informal markets is not fully relevant as, among other things, differences in borrowers' transactions costs are not accounted for.

Borrowers' as well as lenders' transaction costs are very low on the informal financial markets. The costs of the borrowers are low primarily because information costs are low or nil, costs for loan collection as well as service delivery are low. Informal market actors successfully manage risk primarily by dealing with clients they know.

Recent case studies from Africa show that the linkages between the formal and the informal sectors are weak and notably limited to deposits of temporary income surpluses with formal institutions. Except the theoretical arguments forwarded by structuralists explaining fragmentation with asymmetric information and differences in transaction costs, the reasons for the lack of integration are poorly documented based on empirical research. Some observations suggest that the financial products are poorly adjusted by formal institutions. Observations in Ghana suggest that prejudiced attitudes towards informal actors constrain integration.

Most interventions through semi-formal actors seem to originate from a perception of unsatisfied needs for credit. Such interventions tend to ignore savings and to be ad hoc in nature without ambitions to establish lasting services. Often, no thought has been given to what will happen at the end of a project period. Institution building has played a minor role in such interventions. Many interventions have emphasised social objectives at the expense of financial viability and sustainability.

A review of recent literature on rural finance suggests that the success stories, in the sense that viable, self-sustained institutions of a scale of significance have been established are relatively few. Similarities between the success stories include a strong emphasis on institution building, deliberate attempts to "copy" informal market actor operations in order to reduce transaction costs and risk and provision of both deposit and borrowing facilities.

The promotion of financial services to the informal sector should draw upon lessons from the past which include the following:

- Macro-economic and sector policies are of profound significance for the evolution of financial markets.
- The promotion of financial services means the promotion of a system of interrelated service providers.
- The informal financial sector is of significant importance in Africa, often accounting for more than half of the transactions. Contrary to the expectations of many, this sector has increased in importance following economic liberalisation.
- Financial services should be provided by viable and permanent institutions. Projects which are not geared at building permanent and financially self-reliant institutions are seldom successful.
- Financial intermediation has to be seen as a matter of providing services rather than as the provision of a production input (credit) and should, at least, include both savings and credit.

The strategic options for promoting rural finance service provision, which in Eastern and Southern Africa primarily means services to small scale farmers, might be the following:

1. Promotion of the informal finance sector, involving:

- Attitudinal change in favour of the informal sector
- Enabling regulation based on a notion of "hands-off".
- Expanding research on the informal sector.

2. Extending formal sector services to informal sector clients, involving:

- Changing the modes of operation of formal financial institutions to make them relevant to the clients rather than attempting to change the clients (through graduation).
- Profoundly rethink how to handle transaction costs and risks when dealing with small clients and subsequent modification of financial products and modes of operation.
- Major efforts on institution building.

3. Linking formal and informal financial institutions, involving:

- Attitudinal change towards the actors on the informal markets.
- Modification of financial products and modes of operation of formal sector actors.
- Major efforts on institution building directed at formal institutions.

4. Creation of new institutions for informal finance, involving:

- Focusing on financial service requirements among small farm households.
- Promoting further experimentation, notably with community based credit and savings associations and village banks with simultaneous efforts to modify operations of (selected) formal institutions and establishment of linkages.
- Making institution building the centre piece of any effort.
- Expanding the role of credit unions.
- Refraining from initiating and supporting ad hoc efforts, generally limited to provision of credit.

7.4.2 Provision of microfinance²

An increasing number of relatively successful informal sector and microfinance institutions have been set up in Asia and Latin America. Basically two models have emerged which have proved sustainable despite the fact that their clientele belongs to the poorest clientele. One model could be called the "BRI-model" based on the experiences made by Bank Rakyat Indonesia, the other the "Grameen model" which incorporates experiences made by Grameen Bank in Bangladesh and its many successor banks.

The "BRI model" is based on a formal commercial bank with a large network of branches which covers the rural areas and which makes the bank being close to its customers. By recruiting fresh graduates and intensive training and retraining the bank officers have changed attitudes towards the rural clients seeing them as creditworthy and worth the attention of the bank in line with that of larger clients. Most of the lending are made against formal collateral on land and property. A precondition for such a system is that there is an efficient cadastral and land registration system, which enables the clients to provide formal collateral and to give the necessary assurances to the bank that the ownership rights of the property are not possible to challenge. The interest rates charged by BRI to its microcredit clients are higher than the rates of its larger borrowers, as the transaction costs are higher. This segmentation of interest rates are possible as the

² In this report interpreted as financial services provided to individuals, households and enterprises with up to ten employees.

competitors in the microfinance sector (principally the informal money-lenders) have similar transaction costs as those of BRI, while other commercial banks are not entering into the microcredit market. Interesting enough the profitability of BRI in the microsector is better than in its ordinary banking operations.

The Grameen model has as a starting point the participatory characteristics of "people's organisations" which exist for the benefit of poor workers, producers or entrepreneurs and are managed by them. The organisations aim towards self reliance, self employment and empowerment of the poor. The model implies that traditional forms of security such as collateral are replaced by a system of collective responsibility within a group of peers and that the solidarity among the group members create a better security to the lender than any available formal security. A fundamental premise is that the borrowers are the best judges of their situation and know best how to use credit when available. Other characteristics of the Grameen model include:

- tailoring programmes to reach women (the women clients are 55 - 90 per cent of all clients in microcredit projects reviewed)
- delivering of credit to the village and neighbourhood level
- quick disbursement of small, short term loans (three months to one year)
- the incentive of access to larger loans following successful repayment of previous loan(s)
- encouraging savings of potential and existing borrowers
- simple procedure for reviewing and approving loan applications
- interest rates adequate to cover cost of operations
- participation in decision-making by clients
- transparent management information and decision-making systems (no banking secrecy)
- high repayment rate, typically 95 per cent or higher
- access to business information and advice to microentrepreneurs
- NGO culture rather than ordinary commercial bank culture.

Grameen Bank itself is by far the largest among the microfinance institutions, established upon the model which bears its name, with 2.1 million borrowers. In Bangladesh itself, other similar institutions (BRAC being the largest) have in total a similar number of clients making Bangladesh by far the most penetrated country (every fourth poor person has now got access to microfinance). The Grameen Bank has also served as an example for numerous microfinance institutions worldwide. Opportunity International has, thus, developed 52 microfinance institutions in 26 countries, Women's World Banking has 45 affiliates in 37 countries while the Accion Network covers 13 countries. All these have their bases in USA and normally are outgrowths of US NGOs. Grameen Bank itself has been instrumental in the establishment of similar microcredit institutions in 19 countries.

The replicability of the BRI model has been much lower, which seems to imply that the conditions behind BRI's success are more specific and more demanding. They include a high population density, a large cadre of educated, unemployed young people who are willing to join the bank at salary levels which are below the market rate, an infrastructure of high quality and a strong and committed leadership and management. There is, however one Sida-supported project, PRODEL in Nicaragua, which has emulated the BRI model, in that a local bank, BANCOPOPOLAR, provides similar services as BRI along with its normal lending to large clients (Box 6).

Box 6. Credits for urban poor in Nicaragua (PRODEL)

In 1993 about MSEK 50 were allocated as SIDA support to the Local Development Programme in Nicaragua, PRODEL. The main objective of this programme is to improve living standards of poor inhabitants of five urban municipalities in the north-western part of Nicaragua. The programme has been implemented in collaboration with INIFOM, the Institute for Municipal Support. About 40 per cent of the funds have been earmarked for two microcredit programmes of a revolving fund nature, one for housing improvement purposes and the other for promotion of micro-enterprises. The stateowned commercial bank, BANCO POPULAR, was selected as administrator of the two funds mainly because it had a network of offices in the region. In the first two years of operation over 2 200 households and 1 300 microentrepreneurs have benefited from the services of the bank. About 10 per cent of the households have benefited from both types of loans. Since the loans have been revolved faster than expected, twice for the housing part and five times for the micro-enterprise part, less than half of the budgeted funds have been released by Sida. Average housing loans have been about USD 650 and the microenterprise loans USD 250. The experience of the two credit schemes are quite promising. Although the bank was instructed not to select clients with household incomes above USD 150 per month defaults have been very low, close to zero for the housing loans (at subsidised interests) and 3-4 per cent for the microenterprise loans (which have been provided at markets rates). The remuneration formula of the bank has been designed in a way to encourage a close appraisal of the clients as well as a fairly elaborate system of loan recollection. For the administration of the PRODEL funds BANCO POPULAR has implemented training courses for its staff and created a profit centre for the poor clients. For PRODEL-2 the bank is willing to discuss a system whereby it shares the credit risk with INIFOM and Sida.

In Eastern and Southern Africa there are successful institutions set up according to the Grameen model. Also here it seems that US NGOs have provided most of the inputs in terms of concept, systems, initial management and finance. Pride Africa is a case in point which now have operations, with a large number of branch offices, in Kenya, Tanzania and Uganda - and in addition in Guinea - and is soon about to extend its programme to Zambia and elsewhere. Africa Housing Fund has an entirely different background (and does not operate on the Grameen model strictu sensu) in that it is a combination of an international organisation (with the diplomatic immunities which go together with that status) and a multicountry NGO, operating microcredit programmes in some 30 African countries. The promoter and current chief executive of AHF is a Swedish national, Ingrid Munro.

7.5 Private capital flows to recipient countries in Sub-Saharan Africa

Private capital now accounts for more than 80 per cent of net long-term flows to developing countries, totalling USD 285 billion in 1996 (Figure 1). These flows are now reaching more countries over and above the dozen or so which have accounted for the lion's share in recent years. For example, private capital flows to Sub-Saharan Africa, while still only around 10 USD billion, are now several times greater than they were at the beginning of the 1990s.

FDI has increased from around USD 25 billion in 1990 to around USD 110 billion in 1996. It is generally argued that these inflows have a positive overall impact on the growth potential of the recipient host countries since they usually bring about investments in modern technology, improved marketing channels and export opportunities, demonstration effects on other investors, and more generally the benefits of an increased integration with world markets.

A survey report (Appendix 5) analyses the recent development of private capital flows to Sub-Saharan Africa, with emphasis on the Swedish programme countries. These flows include FDI, portfolio equity, commercial bank lending and other private flows. The study focuses on FDI, since this constitutes the most significant net inflows of private capital to the region. Moreover, FDI seems to have a larger real impact on the recipient countries, compared with other more short term private flows.

It can be argued that the increase in FDI and other private foreign capital flows to the countries in Sub-Saharan Africa observed in recent years is important in relation to the limited private domestic investments taking place. Moreover, even small capital inflows may have important demonstration effects on domestic and other foreign investors. These private flows could be crucial for the future growth potential in the region, especially when official development assistance is on the decline, both in absolute and relative terms.

Despite the low level of FDI in absolute terms, the share of FDI inflows to gross fixed capital formation is substantially higher in Sub-Saharan Africa compared with other developing regions. The relative importance of FDI in capital formation has also increased markedly over time. Portfolio equity flows and commercial bank lending to the countries in Sub-Saharan Africa are yet small, but the recent signs of an increase are encouraging. In addition to recorded capital inflows, we also have substantial private transfers by individuals, of which a large portion is believed to be related to returning flight capital.

The current capital inflow episode to developing countries represents a sharp break from the experience of the debt crisis. While the surge in foreign capital constitutes a welcome relief from the constraints of credit rationing for many countries, it also poses some policy challenges. Massive inflows of foreign capital can have problematic macro-economic effects if not adequately counteracted by economic policy. In particular, large short term capital inflows might spur inflationary pressure if the resources are not efficiently intermediated to productive investments. Exchange rate appreciation may also be a problem during periods of massive inflows.

However, in the case of Sub-Saharan Africa, private flows are mainly attributed to long term FDI, which has been shown to have a less adverse impact on macroeconomic stability. FDI is primarily for productive investment in real assets in the host country. Nevertheless, it is crucial that the countries in the region strive towards macroeconomic stability, and it should be pointed out that more research is needed about the impact of FDI and other private capital inflows on stability in Sub-Saharan Africa. Since many countries in the region still face serious macroeconomic problems, there is a need for caution and an adequate policy response, including structural reforms, as means of minimizing possible adverse effects related to capital inflows.

A number of studies have investigated the relationship between economic growth at the aggregate level and inward FDI. On the whole, the results suggest a positive relationship. Furthermore, the effect of FDI on growth holds especially when the host country has a minimum level of educational attainment. This suggest that countries must have a minimum "receiver competence" in order to gain from spillovers and other benefits related to FDI. In countries with very low educational attainment, FDI projects are likely to become "enclaves" relative to a backward domestic economy.

The majority of African countries are keenly interested in receiving FDI and other private capital inflows, which is in sharp contrast to the situation in the 1960s and 1970s when most governments were hostile towards foreign companies. Most countries in the region have recently improved their regulatory frameworks relating to FDI, and provided various incentives aiming to attract FDI, or are in the process of doing so. However, this have not yet led to any substantial volume of FDI inflows. Of course, the response by investors to deregulation and incentives takes time, and may not yet have materialised.

There are however, a number of crucial conditions for FDI are still lacking in the region. In several aspects Africa as a whole does not compare favourably to foreign investors. These include; (i) political instability, (ii) debt overhang and shortage of foreign exchange, (iii) inadequate institutions, legislation and financial systems, (iv) low levels of education and skills, (v) small domestic markets, (vi) poor infrastructure and (vii) low reliance on privatisation and debt equity swaps to attract FDI. In order to attract more FDI and other private flows, these conditions must be improved. Deregulation and incentives with respect to FDI will have a limited impact if other basic conditions are lacking.

Box 7. Pension fund investment from aging to emerging markets

The rapid aging of populations in the rich economies can be expected to stimulate strong growth in private funded pensions, providing a massive potential of foreign finance for developing countries. Pension managers can reap big diversification benefits by investing on the emerging stock markets of the younger economies, benefits which are largely unexploited so far. The authorities in OECD countries should consider removing regulatory constraints imposed on pension assets that deprive retirees from pension -improving benefits of global diversification. Policy makers in developing countries should design policies that reassure institutional investors on default risk and stock market illiquidity, if they want to tap a higher share of OECD pension assets. At the end of 1992 funded pensions in the OECD area alone had assets of almost USD 6 000 billion. In view of demographic trends and the shift from traditional state pensions to funded private schemes OECD pension funds are expected to manage a total of USD 13 000 billion by year 2000. About 3 per cent , i.e. USD 350 billion, of these assets are believed to be invested in emerging stock markets. In the decade up to year 2010 an additional USD 40-60 billion will be invested annually in these markets. (OECD Development Centre Policy Brief)

The following four broad areas of involvement by Sida are recommended:

First, of highest priority is to aim at macro-economic stability including a sustainable external debt situation, to improve the business climate, increase privatisation, to establish efficient financial systems, to reduce bottlenecks relating to infrastructure, and to increase training. All these efforts can be pursued at a rather detailed level, i.e. removing specific bottlenecks relating specifically to a potential FDI inflow.

Second, also of high priority, is to assist programme countries to take advantage of the linkages to South Africa, and possibly other more advanced African countries, as regional growth poles in their efforts to increase capital inflows. Hence, it should be important to promote regional integration.

Third, promotion of Swedish enterprises to invest in program countries. This area may be explored in the future when business conditions in host countries are improved. In this respect, it should be highlighted that Swedish private investments in Sub-Saharan Africa

(and other program countries) are very small to date. This is partly related to the lack of colonial and other historical and cultural ties with the region.

Fourth, Sida should continue to participate in multilateral efforts, such as those undertaken by the World Bank, IMF, United Nations and European Community, both by providing financial resources, and to actively stimulate the policy dialogue.

Needless to say, it is also important that Sida continues to assist countries in improving the general workings of the economy including inflows of capital, e.g. an open trade regime and domestic deregulation.

8. THE SWEDISH RESOURCE BASE

8.1 General considerations

Transfer of know how and experience in the form of technical assistance will constitute the major component of Sida's involvement in financial sector development projects. In order to ensure a high quality of the projects, it is essential that Sida has access to adequate competence from various segments of the financial sector.

In this respect, Sida has adopted the policy to use the Swedish resource base whenever relevant competence is available. Sida also aims at deepening the knowledge of the domestic resource base about the specific problems encountered in the host countries, thus enabling Sida to support a wider range of projects. The main reason for this policy is that the use of Swedish resources facilitates the implementation of the various phases of the project cycle and enhance the interest of the Swedish financial business community in Swedish development cooperation activities in general and Sida's development activities within the financial sector in particular.

8.2 Assessment of the domestic resource base

The Swedish financial business community does offer a deep and broad competence resource base, well in level with that of other industrialised countries.

On the macro level there are several public and government institutions with relevant qualified competence, including the Ministry of Finance, Sveriges Riksbank, the Financial Supervisory Authority and the Swedish National Debt Office.

The commercially oriented part of the financial business community comprises a wide range of institutions. The banking system includes commercial banks, savings banks, investment and merchant banks, mortgage institutions and finance companies. Among actors in the securities markets, the Stockholm Stock Exchange constitutes an important source of competence. The Stockholm Stock Exchange is the seventh largest in Europe in terms of turn-over and is technically in the front-line compared with other major stock exchanges. Another important actor is the Swedish Central Securities Depository and Clearing Organisation. There are also numerous of securities trading companies such as dealers, stock brokers as well as mutual funds and fund management companies which may contribute to the resource base. In the insurance sector the supply of non-life and life insurance companies including pension insurance companies, pension funds and pension fund management companies is well provided for.

Among non-commercial promotional organisations there is a willingness to contribute with expertise. Such organisations are for example the Swedish Association for Share Promotion, the Swedish Shareholders' Association, the Sweden Bond Promotion and the Swedish Bank Association.

Public as well as private education and research institutions offer their competence in financial sector development. They include the Industrial Institute for Economic and Social Research, the Stockholm School of Economics, the School of Economics and

Commercial Law in Gothenburg, the Stockholm and Uppsala Universities and the Institute for Computer-aided Management School of Business.

Finally, the consultant firms and the individual consultants which may undertake financial sector development missions are an important part of the resource base. Many of those with considerable experience from work in senior positions in multilateral organisations and major Swedish and international financial institutions or regulatory bodies.

The Department of Infrastructure and Economic Cooperation of Sida maintains a data base of all institutions, firms and individuals which have expressed an interest in cooperating with Sida in its financial sector assistance.

8.3 Experience from cooperation with the resource base

In conjunction with the establishment of the "new Sida", a group was set up with the mandate to work with financial sector development in Sida's recipient countries. As part of the preparatory work, Sida contracted in October 1995 the Union of Consultants, Scandinavia to investigate the interest of public and private financial institutions, consultancy firms and individuals to work with financial sector development in the third world. This investigation resulted in a list of some 70 institutions, firms and individuals with a potential interest to cooperate with Sida.

The general experience from the cooperation during the past one and a half years is positive. Around 30 institutions or firms of the resource base have been involved in different kind of financial sector development missions for Sida, ranging from seminars arranged by Sida to desk studies. In addition, approximately ten field missions have been undertaken. Almost all names listed in the data base have been approached and several new contacts have been established and added to the data base. Below is outlined a summary of the result of the efforts to deepen the cooperation with the resource base during the past one and half years.

As regards public and semi-public institutions, deepened contacts have been established in particular with the Financial Supervisory Authority. The authority has provided lecturers in seminars arranged by Sida. Retired staff members of the authority have been contracted for project preparatory missions. The Director General is a member of the reference group of Sida's financial sector review. The authority also looks positively on allowing employees to undertake short term missions for Sida but has, however, limited capacity to participate in formal twinning arrangements.

The Stockholm Stock Exchange has contributed actively by providing lecturers, advise and support for the arrangements of seminars. Staff from the Stock Exchange has provided valuable expertise on capital markets for the benefit of financial market development projects. The head of the Research and International Markets Department is a member of the reference group of the financial sector review. The Stock Exchange encourages employees to undertake short term missions for Sida. However, as for the Financial Supervisory Authority, the Stock Exchange has limited possibilities to participate in formal twinning arrangements.

The Swedish Central Securities Depository and Clearing Organisation has expressed an interest in project preparatory work as well as to be a technical partner in twinning operations in developing countries.

Previous staff members of and consultants to the Swedish Bank Support Authority (May 1993 - July 1996) have been employed by Sida for assignments related to management of banking crisis.

Contacts have also been established with several private entities in the financial sector. Swedbank, one of the largest banks in Sweden, has expressed interest in Sida's financial market development projects. A director of Swedbank is represented in the reference group of the Capital Market Study. Through Swedbank contacts have also been established with the World Savings Banks Institute - an organisation which promotes the development of its member banks around the whole world, including many savings banks in developing countries.

Fruitful contacts have also been established with the insurance company Folksam. Folksam is actively supporting mutual insurance organisations in developing countries, mainly through the International Co-operative and Mutual Insurance Federation, ICMIF. ICMIF and Folksam are potential partners in institutional development projects in the insurance industry.

A possible cooperation on commercial terms is about to be established with a major Swedish fund management company, specialised on the management of emerging markets securities. Should it realise, the project would be an interesting example of how Sida can facilitate the entrance of commercial actors in projects which would otherwise be considered too risky.

Representatives of several support and interest organisations have participated as lecturers in the capital market seminar arranged by Sida during the fall 1996. Sweden Bond Promotion has declared its interest to participate in Sida's financial sector development activities.

The Stockholm School of Economics has contributed to the arrangement of seminars for capital market actors in the Baltic states and countries in southern Africa.

Finally, researchers of various academic institutions have performed studies on different issues of financial economy on behalf of Sida.

Box 8. Advanced training in capital market development for participants from Southern and Eastern Africa

Since 1979 BITS and Sida have offered advanced international training courses in Sweden for participants from developing countries. In 1996 Sida offered two courses related to financial sector development, one in bank management (the 7th of its kind) and the other a seminar in capital market development (for the first time). The objectives of the latter seminar was to provide increased knowledge in capital market matters (legal framework, regulation/supervision/enforcement by government authorities, macroeconomic aspects, equity markets, bond markets, the role of promotional organisations, capital market trends and innovations, etc.) to 24 selected participants in managerial positions from Uganda, Zambia, Namibia, Tanzania, Botswana and Zimbabwe. The seminar focused on aspects related to the development of national securities markets. The participants, coming from the public as well as the private sector, formed six *country teams* which during the three weeks course were given tasks to prepare action plans for the development of the stock exchanges in their respective countries. The seminar was implemented by Conceptor International Consulting AB in close collaboration with the Stockholm School of Economics and the Stockholm Stock Exchange. Lecturers from the Central Bank of Sweden, the Financial Supervisory Authority, the Swedish Central Securities Depository and Clearing Organisation, SWEDBANK, the Swedish Shareholders Association, the Swedish Association of Share Promotion and Swedish Bond Promotion were also invited to participate at the seminar. The seminar was highly appreciated by the participants, not least because of the links that were created between institutions and individuals engaged in capital market promotion in southern Africa. As a result of the seminar Sida has received a number of requests for technical assistance in capital market development.

8.4 Conclusions and recommendations for future cooperation with the resource base

The general impression from the cooperation with the resource base during the past one and half year is very promising. In principle, all institutions, firms and individuals that Sida has had contacts with have been positive to a continued cooperation. The same conclusion was reached in the study by Union of Consultants in late 1995. Whether this is a good evidence of the financial actor's positive attitude to Swedish aid is difficult to say. There is of course also a commercial interest for the resource base, although many parties seem to have a genuine interest in the global developing process. As regards institutions and authorities, many see a cooperation with Sida as beneficial for their own organisations. Lastly, the structural adjustment process that the Swedish financial sector, especially the banking sector, has gone through during past 7 years have undoubtedly contributed to the supply of available expertise.

8.4.1 Alternative ways of using the resource base

The most common form of cooperation with the resource base is to procure the relevant expertise for carrying out projects on behalf of Sida. However, cooperation with the resource base can also be organised in other ways.

The most extensive form of cooperation is to establish a twinning arrangement between an institution in Sweden and its counterpart in a developing country. A twinning arrangement is normally a long term mission whereby the Swedish part undertakes to provide training and transfer know-how to develop its counterpart in the developing country in accordance with an agreement concluded between the two parties. Sida is currently supporting such arrangements involving among others Swedish National Audit Bureau and Swedsurvey.

Another way of making use of the resource base, less far-reaching than a twinning arrangement, is to contract a Swedish institution for a specific project or part of a project. It might be short term training missions, such as the mission carried out by the Stockholm Stock Exchange in Tanzania during one week in 1996 for a group of financial journalists. It could also be more extensive institutional development missions, possibly in cooperation with other aid organisations.

A third way of making use of the resource base, is by sending out employees of Swedish financial institutions on short-term missions for Sida. The formal contract for the mission is concluded between Sida and the employee himself after approval by the employer. Many institutions consider this as a good opportunity for its employees to broaden their competence and to gain valuable experience. This form of cooperation could, thus, be regarded as mutually beneficial for Sida and the institution.

8.4.2 Recommendations for the future cooperation with the resource base

- Make the resource base aware about Sida's policy and strategies for financial sector development.
- Clarify for the resource base the internal distribution of responsibilities within Sida regarding financial sector development work.
- Support financial institutions and authorities to engage in twinning arrangements when relevant.
- Establish and maintain a data base of the resources including brief details of performed missions, special expertise, etc. (Such a data base is under way to be established)
- Establish a policy to communicate with the resource base. Elements of such a communication policy could include:
 - * Arranging regular information gatherings, for example breakfast gatherings and lunch seminars.
 - * Organising direct mailing to the resource base of information on new projects, project assessments, general trends in financial markets development, events of interest, etc.

9. Sida's PROVISION OF CAPITAL RESOURCES

9.1 General considerations related to provision of capital

Provision of capital by donor agencies will continue to be a major instrument in financial sector development in low income developing countries. The main reasons for this can be summarised as follows:

- the overall low level of domestic savings; for example even if savings in Eastern and Southern Africa were to increase from 6 to 10 per cent of GDP in the next decade, this is still very low compared to other regions
- the unsatisfied demand for capital from target groups favoured by Swedish aid programs (small and medium sized enterprises, micro-enterprises, smallholders, other low-income rural and urban groups)
- the unsatisfied demand for investment capital for purposes linked to public enterprise reform (including the need to upgrade infrastructure services)

- the poor state of the financial system in target countries. It will take considerable time to develop new financial institutions which are capable of satisfying the demand for capital resources from the public and private sectors
- the "crowding out" effects of the public sector are still impeding the necessary growth of the private sector in the majority of Sweden's recipient countries (without foreign capital inflows these effects would last longer)
- the difficulties in attracting substantial amounts of foreign private capital (official development finance may however be used in innovative and catalytic ways in order to speed up the increase of these flows)
- the short supply of indigenous risk capital in target countries. This makes it difficult for domestic entrepreneurs to develop viable and sustainable financial institutions

As to the magnitudes of capital needed in the future it may be mentioned that annual private investments in developing countries in 1995 amounted to about USD 700 billion, which in turn correspond to about 18 per cent of GDP (World Bank 1997). Even if a major portion of the future capital requirements would be supplied from domestic sources and one third would come from foreign private sources, there is considerable scope for official development finance - particularly in the least developed countries.

The justifications for using aid funds for financial assistance in favour of commercially oriented financial institutions may be grouped as follows:

Market failures, i.e. the institutions are not able to attract funds, be it equity funds or credit lines for on-lending, in the market. The main reasons include overall shortage of capital willing to take medium or long-term risks, and the lack of track record from banking operations etc.

Pluralism and competition. Support to a financial institution may be used as a measure to promote competition in a monopolistic or oligopolistic type of market.

Demonstration and experimentation. Financial assistance (often in combination with technical assistance) may be undertaken in order to promote the introduction of new types of financial services, sometimes implying the establishment of new institutions (which been successfully tried in other countries or regions) and sometimes for the development of new financial instruments and products.

Catalytic effects in the capitalisation of financial institutions. Donor contributions, particularly in relation to equity investments, may have important effects in the capitalisation of recipient institutions. As the equity capital forms the basis for the firm's lending capacity, such investments may be particularly important for mobilising financial resources. Capital ratio requirements are also often part of the regulating framework. It could therefore be argued that the multiplier effect of equity investments is generally larger than that of loans. A capital investment without a repayment obligation on the part of the recipient or without any particular collateral serves as an indication that the investor has confidence in the recipient institution and its capacity to conduct its business in a manner acceptable to the investor. This may create confidence with other investors, lenders and business partners.

9.2 Credits and guarantees

Increased efficiency and flexibility were two of the main motives behind the creation of (the new) Sida. As to the transfer of financial resources this implies increased use of the credit and guarantee instruments in development cooperation. On the basis of a comparative analysis of various forms of transfer of financial resources, the Concessionary Credit Review suggests that a) grants should not be provided to commercially oriented projects, b) credits to such projects should as far as possible be provided on market terms and c) conditional loans (in which the interest and repayment terms are linked to the financial performance of the beneficiary institution) are suitable alternatives to direct equity investments and d) guarantees to such institutions may be used as an alternative to equity investments and credits.

The survey on Swedish aid in the financial sector (Chapter 5) provides support to the recommendations just mentioned and confirms the importance of the "discipline" motive in favour of credits and the need to avoid markets distortions when designing financial assistance for commercially oriented financial sector projects. In view of the stagnating official development finance resources the recycling of money flows from amortisations and interests related to financial sector credit operations will furthermore become even more important in the future. This review therefore supports the recommendations put forward by the Concessionary Credit Review when it comes to increased use of credits and guarantees in development cooperation.

Box 9. Pungwe-Mutare Water Development Project - a case of synergy creation in the local capital market

In 1995 MSEK 100 were allocated by Sweden as a grant (concessionary credit funds) to the government of Zimbabwe for the construction of a water development project in the city of Mutare. The total cost of the project (transport of water by gravity 70 km from the river Pungwe to the city) amounts to about MSEK 800. The Swedish contracting firm SKANSKA won the bid for the implementation of the project. About 35 per cent of the grant is used for credit enhancement purposes. MSEK 35 are channelled through a Water Development Trust, which in turn provides a subordinated loan to the city of Mutare, enabling the city to raise about MZWD 400 in municipal bonds in the local capital market to cover costs incurred in local currency.

This is the first time that a Zimbabwean municipality could issue bonds in the local market. Thanks to the enhancement of the bond issue created by the subordinated loan investors in the local capital market, e.g. pension funds and insurance companies, were able to make investments in a financial instrument with a fixed rate of interest and with a considerably longer maturity than is normal (16 versus 5-8 years) in Zimbabwe. The concessionary credit for the import of goods and services from Sweden and the additional grant for local finance enhancement have therefore - apart from improving the supply of household water for the inhabitants of Mutare - contributed towards the broadening and the deepening of the local capital market in Zimbabwe.

9.3 Microfinance

A large majority of the population in developing countries has so far obtained few benefits from formal financial institutions (normally defined as finance actors that are governed and controlled by financial legislation and central bank supervision and control). In many Sub-Saharan Africa countries, less than 5 per cent of the population is served by formal or semi-formal (non-indigenous and non-traditional) institutions. At the same time, there is a growing awareness about the importance of the fact that the rural poor, the urban

poor, micro-enterprises and others who operate outside of the formal sector have access to financial services (not only credits but also savings deposits and payment services). Recent studies on poverty reduction have highlighted the need to ensure better access of the poor to essential factors of production such as land and credits. Private sector assessment studies show that micro-enterprises are a major source of income and employment in a number of Sweden's recipient countries and that the possibilities for these enterprises to improve the productivity and to expand is linked to the question of financial services. Microenterprise development is especially important for women, who often find themselves without access to jobs in the formal sector due to lack of training and/or competing demands of household duties.

Most international donor agencies have a poor track record when it comes to micro-finance. Assistance has often been provided in the form of project-centred interventions paying little attention to the need to develop sustainable financial intermediaries geared to mobilise local funds and to satisfy the demands of the end users. Furthermore financial assistance has often been provided on very soft terms, which in turn has made it difficult to establish norms for good repayment behaviour and has led to support of non-economic project activities.

Structural adjustment including the liberalisation of the financial sector in developing countries has improved the possibilities for donors to support more sustainable and market oriented institutions in the field of microfinance. At the same time there is now an improved knowledge about the characteristics of such institutions which have succeeded in achieving operational efficiency (defined as covering with client revenues all administrative costs and loan losses) as well as financial self sufficiency (defined as operational efficiency and capability of mobilising finance on market terms). Examples of the latter type of institutions are found in Asia and Latin America. They have frequently adopted the model, which the Grameen Bank in Bangladesh has established. In recent years a number of new initiatives have been taken by the donor community to step up microfinance assistance. One example is the World Bank-initiated CGAP (Consultancy Group to Assist the Poorest) and another is the IDB-initiated MICRO 2001 Program. A third is UNDP's MicroStart Program. A Plan of Action was endorsed recently by a Microcredit Summit, which calls for a comprehensive approach towards eradication of poverty where microcredits will play a pivotal role.

In line with the Action Plan from the Microcredit Summit, Sida should prepare and submit an action plan on microfinance by 28 February 1998.

9.4 Investments in equity

It has been conceived to be a disadvantage that Sida is not in a position to take up equity positions in commercial operations, be they venture capital companies, leasing companies, commercial banks or any other kind of financial institution. *Equity* is defined as owner capital in a formal sense - quasi-equity and unsecured loans may carry almost the same risk as equity, but in a formal sense they do not entitle the investor to participate at shareholders meetings to elect the Board of Directors and to exercise other rights of a shareholder. This section discusses some of the advantages and disadvantages for a donor agency to provide equity capital.

9.4.1 Advantages

Apart from the mentioned general factors which talk in favour of financial assistance by donors there are *specific advantages* when it comes to equity investments:

- Equity investments are made according to a legally well *regulated procedure*. Share subscriptions or acquisitions do not necessitate complicated ad hoc agreements.
- Equity investments may be used to facilitate for domestic investors to eventually become owners, either because the donor sees himself as providing a *bridging investment* or that he can initially act as a *mentor* to other owners. This may become the effect of the *confidence* created.
- Equity investments make it possible for the investor to exercise *influence* by participating in the deliberations of the recipient institution's Board of Directors. Equity investments thereby provide the possibility for the donor to direct the institution towards areas of priority to the donor.
- Equity investments can enhance *competence building* through the investor's active participation in the meetings of the Board of Directors.
- The Board representatives can also make direct contributions to the *business development* of the institution, e.g. through monitoring the drafting of strategic business plans.
- Ownership and Board representation provide the investor with an insight into the company, which may be valuable in order to reach some of the above mentioned objectives. This insight can also be important for *monitoring and control* purposes. In this way, it is possible to control how the donor contribution is used and to follow up that the institution is working towards agreed goals.
- A further positive effect of equity investments may be that the active participation in the governance of these institutions will result in a greater *understanding* of the prerequisites and conditions in the host country regarding the functioning of the capital market. This "transactional experience" may in turn provide ideas for technical assistance projects aiming at improved overall conditions for capital market development in the host country. In addition valuable and strategic contacts may be established with persons with an in depth knowledge of the sector.
- Finally, a major advantage with equity ownership as opposed to financial contributions on a grant basis is that the recipient is under the obligation to endeavour to ensure a return on the capital.

9.4.2 Disadvantages and risks

However, providing donor funds through equity investments may also entail important risks and disadvantages:

- First, an obvious risk with equity investments is that the supported institution can go *bankrupt* and that the invested capital is lost.

- Equity investments involve a substantial *commitment* to the company. It may, for example, become necessary to make *additional capital* investments, should the company expand or experience solidity or liquidity problems.
- As referred to in the previous section, an active owner and board member may acquire substantial influence in the company. Conversely, this influence may lead to a *responsibility* for the company which goes far beyond the financial responsibility.
- Equity ownership necessitates a high degree of flexibility and a capability to make quick decisions. The question is whether a donor agency can meet these requirements.
- The responsibility for the company's business also implies making and defending unpopular decisions which might be discussed publicly. This could lead to negative publicity for the donor and also to other kinds of pressure or bad will.
- If the management of the recipient institution is weak, there is a risk that the donor will have to assume management responsibilities, which would be unfortunate from the donor's perspective. In order to relinquish this responsibility, the donor may have to undertake the time-consuming task to build a competent management that could resume responsibility for the company.
- It becomes increasingly difficult to be a *neutral actor* on the market the more active the donor is or the larger portion of the company the donor owns. The donor should generally be interested in the development of the capital market as a whole and not only in the development of particular companies. Conflicts can therefore arise within different projects or in relation to other companies in the market. From the perspective of other companies, the donor's credibility can be damaged if he is both owner *and* a contributor to the development of the sector as a whole. This may create conflicts in relation to other development projects and in relation to other market actors.

9.4.3 How to organise ownership

It has implicitly been assumed above that equity investments would be made in a donor agency's/Sida's name. It would however, for different reasons, be preferable not to make equity investments in Sida's name. First the Swedish Government has established Swedfund International as its principal instrument for equity investments in developing countries (albeit the main role of Swedfund is not to undertake financial sector operations but to take equity positions in joint venture companies with Swedish partners). Second it has to be possible for Sida to run different projects within a country's capital market. Equity investments could, as was previously mentioned, lead to conflicts of interest and create difficulties as the donor no longer is or is at least not perceived as a neutral actor. Third Sida as a Swedish Government agency should refrain from taking a direct ownership role in investment companies according to general Government guidelines.

The principal way to enable Sida to take part in the development of equity markets at a project level would be to continue the present arrangement with Swedfund. It implies that Sida backs Swedfund up with conditional loans in order to refinance some of Swedfund's equity investments in the financial sector. Needless to say such investments are made

within Swedfund's general policy framework. The investments thus refinanced by Sida would appear as assets on Swedfund's balance sheet.

An alternative way to support equity investments in the financial sector would be through financial sector companies established in Sweden, in recipient countries (second tier financial institutions) or in third countries. This will of course increase the diversity of the Swedish aid programme and would have the added benefit of mobilising Swedish capital market funds for investments in developing countries or strengthening second tier financial institutions in recipient countries. The disadvantage may be that this method would entail a further reduced possibility to influence the management of the investments.

An additional possibility, which in certain situations may be preferable, would be to establish a trust fund in a recipient country, which would be the formal owner of the company while the competence building role is performed by Sida and its consultants. Such trust funds may for instance act as "parking lots" for equity positions which, as part of a privatisation process, are being sold out to the general public through a stock exchange, but where the depth of market is not sufficient to absorb the whole stock issue immediately.

In addition - and as the financial sector interventions by Sida expand - it may be worthwhile to consider the establishment of a separate holding fund for the ownership of Sida's equity acquisitions made within the framework of capital market development. The fund would formally be a subsidiary of Swedfund International but should be co-managed by Swedfund and Sida.

Box 10. Tanzania Venture Capital Fund

SwedeCorp decided in 1993 to invest MUS\$ 0.5 in Tanzania Venture Capital Fund. The investment was made through Swedfund which is backed up with a conditional loan of the same amount from SwedeCorp (this loan is now an asset in Sida's balance sheet). The other international investors in the fund are CDC of Britain, DEG of Germany, FMO of Holland and PROPARCO of France. The National Provident Fund and Tanganyika Development Finance Limited are the two major local investors. The fund has a total capital of MUS\$ 7. The management of the fund is entrusted to a management company which has received financial support from USAID and ODA of Britain. The staff of the management company execute active owner functions as board members of the investee companies. So far the fund has made investments (with a maximum 25 per cent of the share capital of any investee company) of about MUS\$ 5.0 in 15 private Tanzanian industrial enterprises. The majority of these firms had an operational track record at the time of the investment. About five of these companies have shown net profits in the last two years. In 1995 Swedfund received USD 20 000 in dividends from the fund. The termination of the fund is expected for the year 2008.

9.4.4 Guidelines

Equity investments can be an effective instrument for the development of capital markets in developing countries.

The risks and disadvantages with equity investments should be thoroughly considered for each project. If the objectives of Sida's contribution can be achieved through other instruments, those instruments should first be considered. This implies that:

- If the purpose of the contribution is the capitalisation of the recipient organisation, financial contributions through loans (including conditional loans and other quasi-equity operations) should be preferred to equity investments. Equity investments should however be preferred to grants as grants would unnecessarily subsidise the other (normally private) shareholders.
- If the purpose of the assistance is to build competence, priority should be given to grant financed training and institutional development projects.
- If the purpose is to influence policies, the possibility of board participation should be considered.

However, whenever Sida will take up equity capital, the following policy guidelines should be adhered to:

- The equity capital should be provided indirectly in order to avoid exposure to the full equity risks. Such an indirect approach could include refinancing by Swedfund International (or its subsidiaries) or any other refinancing or underwriting mechanism (such as the use of trust funds established in the recipient countries).
- Whenever Sida refinances, guarantees or underwrites equity or quasi-equity participation by other institutions, such refinancing should not cover the full participation. The institution acting as intermediary for Sida's investment should also bear some of the commercial risk related to the investment.
- Equity investments supported by Sida should never aim at majority ownership. Should other partners fail to meet their commitments or they aim at becoming a majority owner, the involvement in the company should be terminated without delay.

Box 11. "Green" venture capital fund for Central America (Corporacion Financiera Ambiental)

In 1995 Sida was invited to participate in the creation of a Central American venture capital fund for environmentally sustainable investments. In 1996 Sida decided to allocate MUS\$ 1 for the capitalisation of the fund. The total capitalisation of the fund is MUS\$ 10. The other investors include Interamerican Development Bank, the Swiss government and FINNIDA. Investments will focus on six types of industries: renewable energy; energy efficiency; sustainable agriculture including forestry and mariculture; pollution abatement; recycling and nature tourism. Rapid economic growth in Central America is taking its toll on the region's air, land and water. However, the region hosts a growing cadre of environmental entrepreneurs launching viable small- and medium-sized businesses (SMEs) which are vital components to realising sustainable development. These businesses are poorly served by the capital markets in the region. Bank lending emphasises short-term maturities and relies heavily on collateral availability. Environmental SMEs require long-term funding which venture capital can offer in exchange for some current yield and share of possible future profits. The fund will strive to involve banks and other local capital providers in its financing of specific investment opportunities, thus giving them comfort with this environmental sector as well as introducing them to venture-style investing. Sida's investment in the fund is administered by Swedfund (ownership of shares) and a regional business promotion agency ASECA (board participation).

10. PROPOSED Sida POLICY ON FINANCIAL SECTOR DEVELOPMENT

10.1 Introduction and purpose

As a follow up of the merger in 1995 of five Swedish development cooperation agencies Sida was mandated by the Swedish government to review its policy in relation to the mobilisation of financial resources in developing countries. The review would include recommendations regarding support to the mobilisation of domestic resources as well as to the promotion of foreign private capital of these countries.

The purpose of this paper is to present a proposed Sida policy for assistance for financial sector development in developing countries, with a particular emphasis on Eastern and Southern Africa. The aim is that this policy will provide guidelines both for direct financial sector assistance and for the design and implementation of financial sector components forming a part of other assistance activities. The policy guidelines will contribute to improved understanding of financial sector issues within Sida and an improved integration of such aspects in projects where they are relevant.

10.2 Definitions and role of the financial sector

An efficient financial sector is one of the pillars of a well functioning market economy. For the purpose of this paper it is assumed that the *financial sector* forms the structure of arrangements in an economy which facilitates the conduct and growth of economic transactions through the use of money for payments, savings and investments. It consists of financial policies and financial infrastructure which support the *financial system* (institutions, instruments and markets). *Financial policies* relate mainly to the money supply, interest rates, public deficit financing and the provision of financial services. *Financial infrastructure* consists of the support for the financial system found in the legal and the regulatory framework governing financial transactions, the practices surrounding audit, accounting and financial disclosure and the operations of the payment system. As to *financial institutions* they include: government entities such as central banks, national debt offices and financial supervisory authorities; financial intermediaries such as banks, microcredit institutions, rural and informal finance institutions, pension funds, insurance companies, leasing companies, risk capital funds and other specialised institutions; financial facilitators such as brokers, credit information agencies and rating agencies. *Financial markets* comprise money-markets (short term debt instruments) and capital markets (equities and long-term debt instruments). *Financial instruments* represent claims to real resources and they may consist of demand and time deposits, bank loans, bonds, debentures, certificate of deposits and shares.

The main functions of the financial sector are the following:

- to reduce transaction costs by providing a stable and widely acceptable medium of exchange
- to encourage savings in financial assets by supplying financial instruments with attractive yields and different maturities
- to improve efficiency of resource utilisation by screening alternative investment proposals and by monitoring the behaviour of borrowers and issuers of equity

- to make risky investments practicable by pooling, pricing and redistributing risks of financial assets

The main objective of the financial system is to ensure that savings from surplus economic units are efficiently mobilised and shifted to high-yielding investments in deficit economic units with an appropriate balance of risk and returns. Smoothly functioning financial systems lower the cost of transferring resources from savers to borrowers and, thus, raise the rates paid to savers and lower the cost to the borrowers. The adequacy of financial institutions, instruments and markets can affect the volume of financial savings mobilised and the efficiency with which they are allocated to productive uses. Confidence among savers and investors is an important element for the functioning of the system.

It is the task of the government to create this confidence and to enable the environment for the operators in the financial markets. The government should make sure that the actors in the market perform in the interest of consumers, investors and savers. The role of the government is therefore to regulate, monitor and supervise the financial system as well as to promote competition within the system.

In recent years the following trends have enhanced the importance of efficient financial systems in developing countries:

- The implementation of structural reforms and the increased recognition by policy makers of the importance to improve conditions for domestic resource mobilisation;
- The decline in the inflow of official development funds;
- The increase in private capital inflows (both portfolio and direct investments);
- The increased demand for capital from the domestic private sector;
- The enhanced efforts to restructure and privatise state-owned commercial ventures;
- The increased capital requirements for infrastructure projects;
- The increased need to restructure social security systems;
- The increased efforts to reduce outflows of flight capital and to stimulate the return of such capital;
- The increased efforts to broaden the ownership of assets and to allow for less privileged groups to benefit from economic growth;
- The deregulation of financial markets,
- The rapid development of information technology facilitating the integration of these markets.

10.3 Prerequisites for successful financial sector operations

In addition to basic assistance related to the promotion of peace, democracy and human rights the following elements are essential for the promotion of efficient financial systems.

Good governance. This implies:

- *The rule of law.* A predictable environment, with an objective, reliable and independent judiciary, is fundamental. Apart from constitutional laws which define the role of public and private sectors, laws related to the management and trade in property rights, contracts, bankruptcies, corporate operations, collateral, debt recovery, accounting, auditing, taxation and foreign investments are essential for financial sector development.

- *Good public sector management.* Public administration should be transparent and have a predictable, coherent and consistent framework of law and government behaviour without a minimum of arbitrariness.
- *Fight against corruption.* Corruption, whether in the public or private sector, undermines the credibility of democratic institutions and results in the misuse of scarce resources. Efforts to reinforce the market mechanism is one way of combating corruption.

Macro-economic stability. Price stability and confidence in the consistency of future economic policies are necessary preconditions for establishing an environment conducive to investment. In economic reform the impact on banks soundness is increasingly taken into account in the design and execution of adjustment programmes. A sustainable external debt situation and an efficient debt management system are other characteristics of macro-economic stability.

Financial market safety nets. Because of the central importance of financial markets to the functioning of the overall economy, most developed and developing countries have established some kind of safety net, designed to protect the overall system and promote consumer confidence. The safety net may consist of a lender of last resort facility at the central bank, potentially in combination with a deposit insurance scheme.

Competitive environment. Another prerequisite for the development of deep and broad markets is the establishment of a competitive environment. The liberalisation of the sector, including the removal of barriers to entry as well the possibility of foreign financial institutions to compete, are some of the measures that are recommended for improved operations. Experiences from financial crises show that a close monitoring and supervision of the financial system by the government and the central bank are essential features of the deregulation efforts.

10.4 Goals and points of departure

Sida's policy will be to contribute to the fulfilment of the overall development goal adopted by the Swedish Parliament - to improve the quality of life of poor people - and the six subsidiary goals - economic growth, socio-economic equality, economic and political independence, democratic development, sustainable use of natural and gender equality. Financial sector development is particularly related to the promotion of economic growth but may also contribute to meeting other goals.

The goal of Sida's financial sector assistance is to contribute to the provision of efficient, sustainable and competitive financial services to the benefit of governments, enterprises, households and individuals.

The main responsibility for the development of the financial sector rests with the government and the various private actors. The role of Sida is to support the efforts of these parties. Sida, apart from providing finance for such efforts, has an important role as concerned participant in the elaboration of financial sector policies in recipient countries and in the design and implementation of assistance projects. Sida may also act as a catalyst for the mobilisation of additional resources for project purposes and as a networking agent for contacts with other foreign partners for coordination and transfer of know-how.

10.5 The comparative advantages of Sida

In comparison to "old history", the merger of the five development agencies has improved Sweden's possibilities to provide efficient financial sector development assistance. Through the newly constituted Sida, it is possible to have a comprehensive and integrated approach to the development of the sector. While the old agencies often made specific interventions at one level of the financial sector (macro, meso or micro) Sida may combine interventions at different levels at the same time.

Sida has the advantage of cooperating directly with both government and non-government parties in comparison with multilateral organisations such as the World Bank. Furthermore, Sida is in a position to employ a variety of aid instruments. Some of these instruments, for example the provision of risk capital, are presently not used by most other bilateral development assistance agencies.

The build-up of in-house expertise in financial matters will facilitate Sida's efforts to develop a close relationship with Swedish institutions working in the sector and this will in turn provide new opportunities for transfer of know-how to the recipient countries.

10.6 Possible areas of assistance within the sector

The following areas in the field of financial sector development have been identified for possible Sida support

Basic legal and regulatory structure

- Legal framework for central banks,
- Legal framework for the banking sector and the capital market
- Rules for prudential regulation and supervision of financial institutions,
- Rules for management of banking crises,
- Regulatory framework for the non-banking sector (including e.g. the insurance sector)
- Rules governing the semi-formal and informal financial sector,
- Rules for foreign ownership of financial institutions,
- Rules related to financial instruments, accounting policies and financial information disclosure.

The objective of support in this area should be to strengthen the financial sector infrastructure.

Financial markets and financial institutions

- Establishment and build-up of money-markets and capital markets;
- Establishment and build-up of banking supervisory authorities, inspection units, national debt offices and other authorities governing the rules of the financial markets;
- Restructuring, corporatisation and privatisation of state-owned banks;
- Establishment of private domestic banks and other financial institutions such as venture capital funds, leasing companies, microfinance institutions;
- Establishment of insurance companies, social security systems and pension funds;
- Establishment of banking associations and other business organisations in the financial sector;

- Establishment of stock exchanges;
- Establishment of shareholders and share promotion associations;
- Promotion of new financial instruments.

The objective of support in these areas should be to strengthen financial institutions and to increase competition in the financial markets.

Capacity to prevent and monitor crises in the financial sector

- Establishment of bank support functions
- Establishment of asset management companies for non-performing bank assets.
- Establishment of deposit insurance schemes

The objective of support in this field should be to improve the capacity for financial crises management in recipient countries. The development of deeper, more complete and transparent financial systems will in itself make countries less vulnerable to financial crises. However, the experience shows that the bank-dominated structure of the financial markets in the majority of Sweden's recipient countries tends to increase the frequency and severity of financial crises. It was acknowledged that the experience of the Swedish resource base is particularly strong in this field as a result of the relatively successful winding up of the recent banking crisis in Sweden. The various institutions which took part in this process have shown interest in cooperating with Sida in this type of projects.

Provision of capital resources

In the restructuring of publicly owned banks or when introducing new non-government financial institutions- be it rural banks, micro finance institutions, refinance agencies, credit insurance units, venture capital funds, or leasing companies- there is often a need to build a capital base in these institutions. In providing finance for equity capital Sida may play a bridging function for market actors to enter as partners in the institutions. When the securities markets for long term finance are not well developed (which is the case in most of Sida's programme countries) there is often a need to provide lines of credits to such institutions or to guarantee or underwrite bond issues.

10.7 Method of work

Country strategies, economic reforms and sector analysis. Country sector strategies developed by Sweden for its major recipient countries will serve as an entry point for Sida's discussions with government authorities regarding assistance for financial sector development. An engagement of Sida in a financial sector project will normally be based on a study of the sector. In most recipient countries such analyses are conducted by the IMF and the World Bank. There is a growing tendency to include financial sector development targets in the structural adjustment programmes ("second generation" of economic reform). Increasingly basic technical assistance for key transformation programmes, such as restructuring of the central bank, is provided by the IMF and the World Bank. Bilateral donors are often invited to complement the work of the multilateral organisations. Financial sector studies provide an assessment of the financial system, i.e. its level of development, depth, width, efficiency in terms of transaction costs for the intermediaries and the beneficiaries of the financial services, obstacles and linkages to regional and international financial markets and involvement of various donor agencies. In countries where Sweden is expected to be a major actor Sida may be engaged in the

work to prepare financial sector studies. One of the functions of Sida's country economists will be to follow and provide information on the development of the financial sector in their respective countries.

Policy dialogue. The efficiency of aid projects in the financial sector depends to a large extent on the commitment of the governments to pursue economic reforms. In connection with discussions and negotiations regarding adjustment support, balance of payment support and emergency assistance programmes Sida will be in a position to recommend policy changes which will facilitate the implementation of various financial sector projects.

Technical assistance. Technical assistance projects will be the normal form of cooperation with recipient country partners - be it government or non-government institutions.

Financial assistance. Financial assistance projects are related to the provision of capital and will take different forms depending on the conditions for the transfer of financial resources. Loans and guarantees can be provided directly by Sida. The availability and feasibility of these instruments will depend on the decisions taken by the Swedish government in relation to recommendations by the Concessionary Credit Study ("kreditutredningen"). Provision of risk capital will normally be made through other agencies such as Swedfund which may act as shareholders and execute owner functions in the financial institutions. Sida may provide refinancing of such risk capital on the condition that Sida will not take the full risk.

Combination of assistance and synergies. Restructuring of state-owned financial institutions often include both transfer of know-how and transfer of funds. In the future there will also be increased possibilities to benefit from synergy effects. For example, financial sector development projects could be linked to the implementation of projects related to concessionary credits and soft loans ("U-krediter" and "biståndskrediter"), restructuring of public enterprises and capitalisation of microfinance institutions.

Initiatives for financial sector development assistance may come from government as well as from non-government parties. Financial sector projects funded by country programmes will be initiated by the recipient country while projects funded from other sources (e.g. funds for Enterprise Development, "Näringslivsbistånd") will be initiated by INEC following consultations with the embassies and the regional departments within Sida.

10.8 Priorities and selection of projects

In countries with less developed financial sectors. The country strategies will provide basic guidelines as to the types of cooperation projects. In a limited number of countries, e.g. countries in Eastern and Southern Africa, a proactive approach will be applied. Priority will be given to assistance geared at creating an **"enabling environment"**, i.e. support for the regulation, supervision and promotion of financial systems. Support for the creation and strengthening of financial supervisory agencies, capital market

authorities, stock exchanges and bank rehabilitation agencies are examples of such support.

Support to private commercial intermediaries in the same country will be avoided or will be made in an indirect, "arms-length" manner, if this will create conflicts of interest with the enabling type of activities. Support to government controlled commercial financial institutions will be restricted to the restructuring of such entities as a step towards corporatisation or privatisation and in areas of market failures (where no private parties have shown an interest to enter).

When support is provided to commercially oriented non-government projects, e.g. leasing companies, venture capital funds and refinancing agencies, efforts will be made not to distort the competition in the sector. Other criteria for selection of projects will be:

- catalytic effects when it comes to attracting capital or know-how from other parties
- innovation and demonstration effects where there are "gaps" in the provision of services to target groups favoured by Sida
- commitment, experience and managerial capacities of the owners of the institutions
- degree of cost sharing
- possibility to promote organisational solutions which are sustainable from managerial and financial points of view and use well established systems of governance (for this reason joint stock companies are often preferable to other forms of for-profit organisations)
- possibilities to involve the Swedish (or Nordic) resource base.

Box 12 provides information on Sida's current programme in the development of the financial sector in Tanzania.

In countries with more developed financial sectors a more reactive approach will be applied. One important criteria for selection will be the extent to which the financial sector project complements the assistance provided by Sida in other sectors. For example, the support to a guarantee fund for microfinance institutions may become a useful complement to a Sida programme targeted at microenterprises and a housing fund may complement a Sida low income housing project.

Sida's financial sector programme can make important contributions to the fulfilment of the goals formulated in the four main Swedish action programmes (poverty reduction, sustainable development, democracy/human rights and gender equality) in development cooperation. (The appraisal, including the use of LFA techniques, of the financial sector projects will facilitate the focusing of the different projects towards these goals).

For all kinds of financial sector assistance Sida will aim at selecting areas where competent and relevant technical know-how may be acquired primarily in Sweden and other Nordic countries.

10.9 Microfinance

Assistance in the field of microfinance will be of importance in Sida's future work towards poverty reduction, rural development and microenterprise development and should form

a substantial part of Sida's poverty-oriented programmes in Eastern and Southern Africa. In order to back up such an approach efforts should be made to mobilise the Swedish NGO sector.

As a short to medium term strategy Sida should support various microfinance projects sponsored by international or local NGOs or other parties, bearing in mind that a principal objective should be to assist only projects which have the possibility to become sustainable. In so doing Sida, should bear in mind the overall financial sector guidelines set out in this paper.

10.10 Development of the Swedish resource base

Sida will pay further attention to developing the Swedish resource base in areas which are essential for the implementation of this policy:

- Basic institutional structure
- Financial markets and institutions
- Prevention and monitoring of crises in the financial sector
- Capital management

Sida will arrange information gatherings and workshops with scientists and representatives of public and private financial entities in order to increase the understanding in Sweden of financial sector issues relating to developing countries.

10.11 Research cooperation

The existence of indigenous research capacity across a wide range of subject areas, both theoretical and practical, is an essential component of a country's ability to analyse its financial sector development issues. Through the instrument of research cooperation (mainly SAREC) Sida will assist in the building and strengthening of indigenous research capacity in areas of strategic importance for the development of the financial sector.

10.12 International networks

This policy conforms to the guidelines on financial sector development forming part of DAC's Orientations on Private Sector Development (1995). In the promotion of financial sector assistance Sida will seek to cooperate with like-minded donors, in particular the Nordic countries. In the European Union, Sida will work for the coordination of member country policies and sector interventions. Moreover, Sida should actively contribute to that the EU assistance conform with DAC's best practices.

Sida will also maintain close contacts with the Bretton Woods Institutions and bilateral agencies (like ODA in England, GTZ in Germany and FMO in Holland) which have shown a particular interest in financial sector issues) especially with regard to the financial diagnostic surveys, the sharing of "lessons learned", the exchange of evaluation reports, the application of techniques for sector assistance and for competence development of Sida staff in these matters.

Financial sector development is one of the most dynamic components and characteristics of the ongoing integration of world economies. Sida will therefore aim at maintaining contacts with institutions in the market (banks, investment management firms, development finance institutions, other financial service companies and financial consultants) which may present new financial instruments and ideas on how to find synergy effects in the use of stagnating official development funds and growing private capital flows to developing countries.

Box 12 . Financial Sector Development - Tanzania

In order to support the development of a well-functioning financial sector in Tanzania, Swedish assistance is based on a holistic approach. Support is provided both to develop an institutional framework and to promote a variety of providers of financial services. The projects below addresses different areas in need of assistance but all with the common characteristic that they are supportive to each other.

1. The Capital Markets & Securities Authority. A government agency. Support (MSEK 8.0) enabling the authority to develop its regulatory and supervisory capacity and to establish and develop the Dar Es Salaam Stock Exchange.
2. First Adili Bancorp Ltd. A private, indigenous commercial bank. Support (MSEK 5.0) in order to establish the bank. A combination of technical and financial assistance in the form of conditional loan (quasi-equity). The bank is focusing on providing both traditional banking services and investment banking services, which at the time of establishment were not provided for in Tanzania.
3. Tanzania Development Finance Company Ltd. A development finance institution owned by local and international financial institutions. The support (MSEK 8.0) in the form of a credit facility will facilitate TDFL 's investments in a variety of locally based capital market institutions. Under the facility TDFL has requested the refinancing of a local commercial bank.
4. Tanzania Venture Capital Fund. A risk capital institution owned by the Tanzanian National Provident Fund, TDFL and a group of international development finance institutions. The support (MSEK 3.0) is provided in the form of a conditional loan to Swedfund which is the owner of the Swedish shares in the fund. The fund makes investments in local industrial ventures. See also Box 10 on page 60.
5. udc (Tanzania) Ltd. A leasing company owned by EDFUND, an international investment fund which has made equity investments in leasing companies in Botswana, Zimbabwe, Mozambique and Tanzania (udc (T) Ltd). These companies provide finance for procurement of vehicles and machinery for small and medium sized enterprises. The support to EDFUND (MSEK 12.0) is channelled through Swedfund which owns 17.5 per cent of EDFUND.
6. A Microfinance institution. Support is being considered by Sida to a microfinance institution modelled on Grameen Bank.

In addition to these projects Sida has provided support to "financial components" of development projects aiming at the promotion of small and medium sized companies and micro-enterprises. One of these projects is the Enterprise Development Programme (EDP) for Tanzania, which includes a MSEK 6.0 credit component.

GLOSSARY OF FINANCIAL TERMS

Below are definitions of a list of financial terms as they are specifically used in this Report:

Capital Market: The market in which long-term financial instruments, such as equities and bonds, are issued and traded.

Chattel: An item of tangible property other than real estate.

Clearing: In the context of the payments system, refers to the transfer and recording of payment instructions made by a payor to a financial institution. Clearing can be done on a gross basis i.e. transaction by transaction or, if channeled through a specialized clearing organization such as a clearinghouse, on a net basis where total receipts of one institution are offset against payments to be made by that institution.

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. Personal guarantees and joint group liabilities are sometimes defined as "collateral substitutes".

Commercial Bills: Short-term debt instruments that are used mainly to finance trade. Examples are promissory notes, by which debtors commit themselves to pay to creditors or to their order a stated sum at a specified date, and bills of exchange, which are drawn up by creditors and accepted by debtors.

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.

Consessionary lending: Loans made at terms and conditions better or easier than standard commercial rates.

Contractual Savings Institutions: Occupational pension funds, national provident funds, life insurance plans, and similar institutions that collect financial savings on the basis of long-term financial contracts.

Convertibles: Securities (generally bonds or preferred stocks) that are exchangeable at the option of the holder into securities of the issuing firm.

Cooperative bank: A bank that is owned cooperatively and formed to lend funds primarily or entirely to cooperatives.

Credit enhancement: Increasing the creditworthiness of a loan, security issue, or other instrument.

Credit Union: A particular form of cooperative savings and credit society that conforms to a structure common in the international credit union movement, represented by the World Council of Credit Unions (WOCCU).

Curb market: A term used for informal finance, particularly in Asia.

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.

Development banks: Specialized banks, often wholly or partly owned by governments, that are created to meet specific financial needs such as lending to agriculture or industry, not adequately met by existing banking structures.

Direct instruments: In connection with monetary policy, refers to actions affecting monetary conditions which directly force banks into portfolio positions they would not voluntarily accept such as aggregate and individual bank credit ceilings, interest rate controls and directed credit policies.

Discount: A reduction from the face value of a financial contract.

Equity Finance: The provision of finance in a form that entitles its owner to share in the profits and net worth of the enterprise.

Factoring: A financial service that buys accounts receivable from companies and then acts as the principal in collecting them.

Financial Depth: The extent to which savings in an economy is channeled through the financial system. Usually measured as the ratio of broad money (M2) to GDP.

Financial Distress: Usually refers to the sharp deterioration of a group of financial indicators resulting in changes in the behavior of the agent before its restructuring or bankruptcy.; When such distress reaches crisis proportions and is widespread, it usually leads to a rush out of real or financial assets into cash.

Financial infrastructure: The framework of laws, regulations and accounting practices governing financial transactions and the logistics and practices of the payments system.

Financial sector: The structure of arrangements in an economy which facilitates the conduct and growth of real economic transactions through the use of money for payments, savings and investment. This structure of arrangements include monetary and regulatory policies, infrastructure, institutions, instruments and markets which are intended to enable the transfer of financial resources with minimal possible risk and cost from payers to recipients of funds and from savers to borrowers.

Financial system: The institutions, instruments and markets in the financial sector.

Financial Savings: The portion of total wealth held in the form of financial assets.

Fiscal Deficit: Defined on a cash basis as the difference between total Government cash outlays, including interest outlays but excluding amortization payments on the outstanding stock of public debt, and total cash receipts, including tax and nontax revenue and grants but excluding borrowing proceeds.

Foreign direct investment: FDI is defined as investment that is made to acquire a lasting management interest (usually 10 per cent of voting stock) in an enterprise operating in a country other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short term-capital as shown in the balance of payments

Formal financial institution: An institution which is governed and controlled by financial legislation and central bank supervisory control

Hedging: The acquisition of a financial contract designed to protect the purchaser or the seller against a future change in the price of a commodity or security in which the purchaser or the seller has an interest.

Indexation: A mechanism for periodically adjusting the nominal value of contracts in line with movements in a specified price index.

Indirect instruments: In connection with monetary policy, refers to policy actions affecting monetary conditions such as interest rates and price levels through use of market forces and financial markets.

Informal sector: Involves activities outside the formal economy such as trading by street vendors, selling of home made products, subsistence farming, home craft production, backyard carpentry and metal working and other activities not enumerated in national statistics and counted in the gross national product.

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.

Leveraged financial institution: An institution, e.g. a bank, that mainly relies on borrowed funds for its operations.

Liquid liabilities: Money plus highly liquid money substitutes, such as savings deposits.

Liquidity Management: In connection with monetary policy, refers to actions taken by a central bank to ensure that the banking system can flexibly provide in the short-run for the cash and payment needs of society.

Micro finance institution: An institution which caters to the needs of individuals, group of individuals and enterprises employing up to ten people.

Monetary policy: Refers to actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of sustainable growth of real output, high employment and price stability. Distinguished from fiscal policy which affects these broader objectives through Government expenditures and taxes (see direct instruments and indirect instruments).

Money: Currency and other liquid assets: Narrow definitions such as M1 refer to money used as a medium of exchange. Broader definitions such as M2 or M3 add to M1 money used as a store of value.

Money markets: Markets in which financial instruments with a term of one year or less are issued and traded. These instruments usually include enterprise bills, commercial paper, bankers acceptances, Treasury bills, and negotiable certificates of deposits.

Nonperforming Loans: A loan on which contractual obligations (for example, interest or amortization payments) are not being met.

Open market operations: A tool of monetary policy through which a central bank can affect reserve money through purchase or sale of securities.

Payments system: The system of logistics and practices involved in settling economic obligations and transferring resources through financial payments. Clearing and settlement are the two major steps in the payments process. The institutional elements of this process include, for example, the system of checks, clearinghouses, girobanks and automatic deposit and payment orders executed by financial institutions including the postal system.

Portfolio equity flows: These flows are the sum of country funds, depository receipts (American or global), and direct purchases of shares by foreign investors.

Prudential Regulation: Refers to the set of laws, rules and regulations which are designed to minimize the risks banks assume and to ensure the safety and soundness of both individual

institutions and the system as a whole. Examples include lending limits, minimum capital adequacy guidelines, liquidity ratios, etc.

Rating institution: An institution that uses financial information to determine the creditworthiness of potential borrowers or customers .

Risk capital: Equity capital and loans in different forms which are not fully secured.

Rotating savings and credit associations (ROSCAs): An informal group of six to forty participants who regularly make a contribution into a fund that is given in rotation to each group member

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

Securities: Financial instruments which can be readily transferred through sale from one owner to another either directly or through the intermediary of specialized institutions and markets. The term generally refers to shares and bonds specifically.

Securitization: The process of conferring the tradeable characteristics of securities to a financial instrument.

Semi-formal financial institution: An institution which is not governed by financial legislation and not controlled by the central bank. At the same time it is not an indigenous and traditional financial institution.

Settlement: In the context of the payments system, refers to the actual transfer of value based on payments instruction through the use of account balances at a financial institution which can be bank balances or on the books of the central bank.

Term Finance: Medium- and long-term debt finance.

Transaction costs: “The costs of doing business” -i.e. costs that are related to finding a buyer, to close a deal and to make sure that the client pays for the purchased good or service. For a lender the transaction costs include the costs for business promotion, information gathering on clients, loan processing, monitoring and loan recovery . For a borrower the costs include out of pocket expenses to obtain documents, assistance to fill in forms, registration fees/stamps, commissions, bribes and travels as well as opportunity costs for time spent in relation to application of loans.

Unleveraged financial institution: An institution, e.g. a pension fund, that does not base its operations on borrowed funds.

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.



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