

The combined role of monetary, foreign exchange and financial sector policies



Foreword

Unstable and weak financial systems are often a cause of delayed or interrupted domestic economic growth. The experience from the Asia financial crisis in 1997-98, from the financial crisis in Russia in 1998, from a similar crisis in the Dominican Republic in 2003 and many other countries show that these crises have serious negative effects on poor groups. These crises have partly been faults in the global financial system in the wake of the liberalisation of financial markets during the 1980's. As such they are today subject for efforts to regulate the global financial system. But they have also been caused by inefficient domestic financial systems. Multilateral organisations such as IMF and the World Bank- often with the support of bilateral agencies such as Sida- have in recent years initiated a number of programs to assist partner countries to create stable, robust and shock-resilient financial systems. In co-operation with the Central Bank of Sweden Sida provides capacity building advice on matters such as monetary policy and capital market reforms to central banks of Uganda, Sri Lanka and Vietnam. Sida co-operates with the aid organisations of Germany, United Kingdom, Holland and Canada to employ a sector wide approach in financial sector development in countries such as Uganda and Tanzania.

In view of the new knowledge and insights regarding the importance of monetary policy for promoting economic pro-poor growth and stability Sida decided in 2002 for capacity building purposes to conduct a number of seminars for its staff. Björn Rosengren, a doctor in economics with vast experience from financial sector development work in Sweden and in developing countries such as Namibia and West Bank Gaza, was commissioned to conduct these courses. As a part of the training programme Dr. Rosengren was assigned to prepare the enclosed Compendium.

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The Assignment

Background

According to its ToR, this assignment aims at producing a Compendium to be used in a Sida Training Programme, focusing on *”The Combined Role of Monetary, Foreign Exchange and Financial Sector Policies, and Financial Stability Development as a Global Utility”*. The purpose is to improve the competence, knowledge and insights of the Sida/INEC Finance (FINANS) Staff. The programme is motivated by ongoing trends as to

- the development (both in breadth/width and depth) of the financial system of the co-operating countries;
- the integration and reform of the world financial system;
- new knowledge and insights regarding the importance of monetary policy for promoting economic growth and stability.

Specifically, these trends increase the requirements on the Sida FINANS Staff to

- monitor these trends;
- be prepared to participate with concrete assistance;
- advise other Sida Departments regarding the design of country strategies; and also
- participate in the policy dialogue with the co-operating countries.

With this background, Sida FINANS assigned Dr Björn Rosengren – inside a subconsulting agreement with Sida – to design and implement a Training Programme, including a Compendium, for Sida FINANS staff during the autumn of 2002.

Purpose

The ToR specified the purpose as follows:

- (1) Increase the FINANS staff’s knowledge of
 - the relations between monetary, foreign exchange and financial sector policies;
 - how these relations influence the reformation of the infrastructure of the international financial system; and

- how these issues relate to Sida's general development objectives (especially economic growth) and the objective of developing the financial sector in the co-operating countries.
- (2) Discuss different ways for the FINANS Staff to get more knowledge about these matters (through contacts in Sweden as well as internationally).

The Training Programme Compendium

The Compendium should according to the ToR include:

- (1) A short account of main terminology, institutions and theories inside its focus area;
- (2) A short account of relevant trends in developing countries. Are there any good examples of successful use of monetary policy in some developing countries? Are there any examples of the opposite case? How (in what ways) have the prerequisites in e.g., sub-Saharan Africa improved as to the implementation of a successful monetary policy?
- (3) An account of the main efforts of the IMF and the World Bank Group using the Financial Sector Assessment Programmes (FSAPs) and Codes and Standards (including new rules inside the Basle System);
- (4) An account of the implication of Financial Stability as a global utility and its connection to the development of national financial systems;
- (5) A discussion of links to Sida's promotion of economic growth and poverty alleviation in co-operating countries (including the potential effects of financial crises on poor population groups);
- (6) Points of view regarding Sida's bilateral assistance as well as co-operation with other donors (including the UN and the World Bank Group) within the areas of Monetary Policy and Financial Stability – including comments on how Sida's ongoing and planned Monetary Policy projects (Sri Lanka and Uganda) and financial infrastructure projects in Africa (Emerging Africa Infrastructure Fund and GuarantCo) may strengthen and complement its general assistance;
- (7) How Sida could expand its co-operation with relevant Swedish institutions inside the areas focused.

Implementation

During the second half of 2002 – in line with the scope and time schedule stated in the ToR - the Consultant implemented his assignment as follows:

- Step 1* The Consultant reviewed relevant literature (via Sida, via Internet etc) and contacted institutions (e.g., Riksbanken) having access to relevant documentation and potential interest in participating in the Training Programme.
- Step 2* The Consultant put together a Draft Training Programme Compendium in English; aimed at the FINANS Department staff.
- Step 3* The Consultant implemented Training Session A (a half-day).
- Step 4* The Consultant implemented Training Session B (a half-day), with beneficial assistance by two Riksbanken officials.

An extended and updated Compendium version

After the completion of the draft version, Sida has requested the Consultant to prepare an extended and updated version of the Compendium during the autumn of 2003 (final date: 03-11-30). According to the ToR, the new version includes

- (a) a general update regarding the role of the financial systems for the development of developing countries, especially as to pro-poor growth aspects, and the reduction of risks of financial crises appearing in developing countries;
- (b) an enlargement of the section on Score Card Indicators (Appendix 1), and
- (c) complementary additions to the section on the Financial Sector Reform and Strengthening Initiative.

The new Compendium version is presented below

1. Frame of Reference

1.1 Sida's General Development Policy

The frame of reference for this document is set by Sida's policy declarations.

Sida's general policy is to contribute to the fulfilment of the overall development goal adopted by the Swedish Parliament, i.e., to improve poor people's quality of life.

The policy includes six subsidiary goals:

- economic growth,
- socio-economic equality,
- economic and political independence,
- democratic development,
- sustainable use of natural resources, and
- gender equality.

Financial sector development is related particularly to the promotion of economic growth but may also contribute to achieving some of the other six goals.

1.2 Sida's Financial Sector Policy

Sida's Financial Sector Policy states that the goal of Sida's financial sector assistance is to contribute to developing efficient, sustainable and competitive financial institutions in co-operating countries.

The goal formulation also includes an ambition to assist co-operating countries in preventing as well as managing financial crises. The main responsibility for the development of the financial sector rests with the co-operating country's government and private actors.

Sida's role is to support the efforts of governments and private actors in co-operating countries. This includes the following:

- (1) Sida should provide finance for such efforts;
- (2) Sida has an important role as concerned participant in the design of

financial sector policies in co-operating countries as well as in the design and implementation of assistance projects;

- (3) Sida may also act as a catalyst for the mobilization of additional resources for project purposes, and as a networking agent for contacts with other foreign partners concerning co-ordination and transfer of know-how.

1.3 Financial Sector Development, Economic Growth and Poverty Alleviation

The financial sector policy is based on the assumption that financial development will promote economic growth and poverty alleviation. This relationship is evidenced by i.a. two INEC/Sida reports:

- (a) *Financial Development, Economic Growth and Poverty Eradication (Isaksson & Levin, November 1999)*, a report which surveys the recent literature on the relation between financial development, economic growth, and poverty alleviation.
- (b) *Financial Sector Development* (June 1997); a report which includes 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 mobilization of financial resources in developing countries, focusing on countries in Eastern and Southern Africa. The review included recommendations regarding the promotion of domestic resource mobilization as well as measures to stimulate inflows of foreign private capital:
- Sida should provide technical assistance related to financial sector development;
 - Sida should also provide financial assistance in the form of loans, guarantees, and risk capital (through other agencies such as Swedfund);
 - Sida's country strategies should provide the basic guidelines as to the type of relevant development projects to be focused;
 - assistance in the field of microfinance would be of importance in Sida's future work towards poverty alleviation, rural development, and microenterprise development.

1.4 Purpose, Sources and Structure of this Compendium

The *focus and ambition of the Compendium* is – based on the ToR – limited to a summary presentation of the relations between monetary, foreign exchange and financial sector policies and financial stability development in co-operating countries.

The Compendium's *literature sources* are listed in the Bibliography (Appendix 2). The main principle of using literature references is as follows. At the beginning of each chapter (Chapters 3 – 7), a general reference is given to the presentation's main sources. Specific literature references are given as an exception when it is motivated. This is so, especially when it facilitates the understanding of the context or could give the interested reader guidance to further details.

The *structure of the Compendium* is as follows:

- Links to Sida's development promotions efforts;
- Focus on monetary, foreign exchange and financial sector policies – main terminology, theories and institutions;
- Financial policy trends in developing countries;
- Global financial stability and the development of national financial systems;
- IMF and World Bank financial sector development efforts;
- Sida's efforts to promote monetary policy use and financial stability;
- Expansion of Sida's co-operation with relevant Swedish institutions.

2. Links to Sida's Development Promotion

2.1 Sweden's Global Development Policies – a Government Report

The links between financial sector development in co-operating countries and Sida's development promotion projects are given a clear-cut formulation in

SOU 2001:96 "En rättvisare värld utan fattigdom". Betänkande av den parlamentariska kommittén om Sveriges politik för global utveckling. (A Swedish government committee report presenting Swedish policies for global development).

Crisis prevention and financial stability

In a section on "Stability in the international financial system" the report states that developments in Mexico 1994 and in South East Asia 1997–98 showed that *bank and currency crises* often occur in tandem and that their effects may hurt a large number of the countries of the world, and cause *large economic and financial losses*, which hurt people very unequitably.

Crisis prevention measures in developing countries as well as in industrialized countries and on an international level are called upon. A combined effort would probably be more cost-effective and contribute to a lower level of risk of another financial crisis which would benefit all people, including those who live close to the subsistence level.

Efforts on a national level in developing countries should focus on institution building and *development of the financial sector*. Included are efforts which create

- a robust and diversified banking system with private banks and a functioning financial supervision authority;
- laws dealing with bankruptcy and liquidation of companies as well as a rapid and impartial legal process;
- necessary conditions for efficient capital markets are linked to the application of *internationally agreed standards, i.e., for accounting and auditing*

Establishing foreign banks may also play a certain role through adding competent banking staff and increased competition within the banking sector. It is also important to underline the importance of a stable economic policy, including trustworthy fiscal and monetary policies, in order to avoid crises and uneasiness in the financial system.

Extensive efforts have been made to *reform the international financial system* and the international financial institutions in order to increase stability. Different organizations and a large number of countries participate in this work. Efforts to increase openness and transparency with authorities, market actors and international organizations have been taken in order to facilitate a better informed decision-making and a better risk assessment, e.g., within the private sector.

Evaluation of policies and institutions

Rules and regulations have been designed to assess financial, monetary and fiscal policies of individual countries. The evaluation also includes institutional issues; national and international payments systems, accounting and auditing, bankruptcy laws, stock exchange trading, and supervision of insurance business.

There is also ongoing work producing regulations for improved and correct national and international statistics, etc. The IMF and other international organizations give expert support and assistance to countries wanting to adjust their legal framework to the international assessment of these rules and regulations.

Further, the international organizations' operations have been reformed to make it possible to better deal with as well as prevent new financial crises.

Handling financial sector deficiencies

In a discussion of the *role of economic policy* for poverty alleviation, the Swedish government report states that *the financial sector*, which constitutes the economy's blood circulation system, is deficient in many developing countries. Poor people have been especially hard hit by the consequences of *national and international crises* in the international financial system as well as by various *economic shocks*.

To come to grips with the problems in individual countries there is a need i.a., for

- increased competition within the banking sector;
- establishing a financial supervision authority, and
- a stable currency.

Further, there is a need for

- a sustainable economic policy, and
- a robust financial system, combined with measures aimed at limiting the damaging effects of hasty, short-term capital flows when the economy is opened against the rest of the world.

With the aim of developing small scale enterprise, introduction of *mini credits*, as a complement to micro credits, may be a highly effective instrument.

2.2 Recommended Areas of Sida Involvement

The government report recommends the following *four broad areas* for Sida involvement:

- (1) Of highest priority is to aim at *macroeconomic stability*. This includes
 - upholding a sustainable external debt situation;
 - improving the business climate;
 - increasing privatization;
 - establishing efficient financial systems;
 - reducing infrastructure bottlenecks, and
 - increasing training.
 All these efforts can be pursued at a rather detailed level, i.e., removing bottlenecks relating specifically to a potential FDI inflow.
- (2) 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*.
- (3) Promotion of *Swedish enterprises to invest in programme 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 programme countries) are very small up to date. This is partly related to the lack of Swedish colonial and other historical and cultural ties with the region.
- (4) Sida should *continue to participate in multilateral efforts*, such as those undertaken by the World Bank, the IMF, the United Nations and EU. This should involve providing financial resources as well as active stimulation of the policy dialogue.

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

2.3 Framework for Sida's Private Sector Development Promotion

A recent consultancy report (*Second consultation draft, August 20, 2003*) outlines a background to a Sida policy for private sector development promotion. The document

- takes its stand in the overriding objectives and values underlying Swedish development assistance in terms of poverty alleviation and gender equality based on a human rights perspective;
- explains how private sector development can be an effective instrument towards achieving these objectives and values, and
- operationalizes this instrument in order to put private sector development to effective use in Sida's work, notably the country strategy process.

The report puts into context the importance, among all other factors, of macroeconomic policy, and the institutional and financial aspects of development, i.e., development factors which are the focus of attention for this Compendium.

3. Focus on Financial Policies – Main Terminology, Theories and Institutions¹

In this context, financial policies represent monetary, foreign exchange as well as financial sector policies – all working together with fiscal policy.

3.1 Monetary Policy in Theory and Practice – a Historical Perspective

3.1.1 *Monetary Policy and the Real Economy*

The main objectives of a central bank can be illustrated by the Swedish case. The Riksbank has two objectives (Nyberg 2002), i.e.,

- maintaining price stability, and
- promoting efficiency and stability in the payment system in a broader context.

Both objectives have real economy as well as financial aspects, and they are more closely linked than might be thought initially. Financial market turbulence has repercussions on economic activity, i.e., the real economy, and thus greatly influences monetary policy. It is difficult, if not impossible, for a central bank to pursue an effective monetary policy when the country's financial markets are functioning inefficiently. At the same time, price stability and expectations of stable, low inflation help to create financial market security and stability.

The view presented above could be looked upon as a present consensus view in developed countries. To get an understanding of the corresponding position in developing countries, a historical perspective on monetary policy theory and practice is useful.

For a century or more it has been accepted that inappropriate monetary policy decisions – as to the price and availability of credit, as well as to the expansion of monetary aggregates – could have damaging effects on price and output stability in the economy as a whole. How monetary policy affects the real economy and what choice of policy is most efficient have, however, remained controversial issues.

In the last few years, many industrial countries have changed their approach to the formulation of monetary policy. These changes have

¹ The text below is based mainly on the following literature sources listed in the Bibliography (Appendix 2): Caprio Jr & Honohan, 1991; Eklund, 2000; IMF and the World Bank, 2001; Kaufman, 1986; Nyberg, 2002; Platt, 1986; Popiel, 1994; Singh, 1992; van Horne, 1983.

accompanied rapid development in the sophistication and depth of financial markets. They have been both a response to this development and a catalyst for it. In developing countries the focus has moved from direct toward indirect methods. Both the evolution of financial markets, and growing disenchantment with directed credit programmes and with bank-by-bank credit ceilings, have led to increased interest in indirect monetary policy methods.

The World Bank has increased its involvement in financial sector development issues, especially through the growing number of structural and sectoral adjustment loans with a financial component. As a result, it has been asked to provide assistance in monetary policy matters. Based on the notion that the mechanisms by which monetary policy is implemented can have important implications for the long-term development of the financial sector, the World Bank has responded positively to these requests. In this area the World Bank works in close conjunction with the IMF, which organization has a main interest in assuring effective monetary policy tools.

3.1.2 Money supply and inflation

Some basic relationships of how the financial sector works in a market-oriented economy are fairly reliably established. For example;

- Over a protracted period, rapid growth in the money supply will lead to sustained inflation;
- An increase in the cost of credit will dampen economic activity and will also tend to slow the underlying rate of inflation despite representing an additional cost to industry. (That is, for an economy not experiencing financial repression. If, on the other hand, interest rates have been repressed to artificially low rates, and credit is rationed arbitrarily, an increase in interest rates may lead to greater availability of credit and an improvement in long-term growth prospects).

On the other hand, there is not a clear one-for-one relationship between monetary growth and inflation in the short run.

- Domestic prices can be sticky;
- Exchange rates can overshoot their equilibrium levels following a disturbance and may even veer away from equilibrium for a while;
- Innovations in the financial sector may alter the equilibrium relation between money, prices, and output in ways that are hard to predict and may lead to an increase in the volatility of this relationship.

Accelerating inflation in many industrial countries in the 1960s and 1970s caused authorities to *review their approach to monetary policy*.

- It became widely believed that the common use of *interest rates as operating targets* for monetary policy had contributed to inflation, as political pressures had combined with policy inertia to slow the response of monetary policy to rising prices. In the absence of fixed exchange rate anchors, at least from the early 1970s, excessive monetary expansion had been tolerated.

- To correct this state of affairs, several industrial countries began to rely more heavily on *the quantity of money as an indicator of monetary conditions or even as an intermediate target*. It was felt that the money supply would prove to be a good leading indicator of inflationary conditions; keeping it under control would stabilize inflation. The degree to which the money supply was targeted – to the exclusion of other factors – varied from country to country. In particular, a certain degree of interest rate stability was also maintained in most countries.

3.1.3 A Broader Approach to Monetary Aggregates as Intermediate Objective

By the end of the 1980s, most governments had formally or informally abandoned the narrow focus on targeting monetary aggregates.

- Instead governments favoured a more eclectic approach that allowed them to *include a number of different indicators of the state of the economy* as a guide to policy;
- They had also instituted *a more flexible regime of monetary instruments*, which allowed them to influence monetary conditions more quickly than in the past and with a graduated pressure;
- At the same time many governments began to allow *a much greater degree of competition in the financial system*; the use of more indirect means of monetary control in this more competitive environment helped to ensure that monetary policy measures were not as easily evaded by disintermediation as they had been in the 1970s.

3.1.4 Direct control

An *alternative approach* to the focus on monetary aggregates as the main intermediate objective of monetary policy has been the use of *ceilings on aggregate credit expansion*. The ceilings were usually ensured by distributing sub-ceilings on a bank-by-bank basis. This approach was widely used in European countries in the 1970s and still forms the basis of monetary policy in many developing countries (especially in Africa). This method has, however, serious negative side-effects:

- The definition of the institutions to be included in such credit ceilings give rise to many opportunities for avoidance through disintermediation and the development of near-bank and parallel credit markets, which greatly reduce the effectiveness of these instruments.
- Bank-by-bank ceilings also distort competition by penalizing more dynamic institutions and discourage resource mobilization; once a bank reaches its credit ceiling, it has no incentive to compete for additional resources, regardless of the profitability of its clients' investment opportunities.

Directed credit programmes have regularly become entangled with the implementation of monetary policy. In particular, a variety of developing countries and several industrial countries have had monetary policy subverted by attempts to exempt priority sector credit from overall or bank-by-bank ceilings. Widespread recognition of the drawbacks of directed credit schemes has led to a decline in their popularity; once willing to reconsider these programmes, authorities have become more willing to examine monetary policy instruments as well.

Developing countries that move to indirect monetary control are likely to experience less certainty when using monetary aggregates as intermediate objectives. It may be less difficult to achieve intermediate objectives that are elements of the central bank balance sheet, but the reliability of these as a means of influencing aggregate demand or inflation remains relatively unexplored for developing countries.

3.2 Monetary Policy – Objectives, Instruments and Institutions

3.2.1 Objectives

Monetary policy refers to the policy, the primary objective of which is to manage interest rates as well as the supply of money and credits. The main responsibility for monetary policy lies with the central bank – contrary to fiscal policy, which is managed by the government and Parliament. The main responsibilities of the central bank are:

- to issue notes and coins;
- to manage the foreign exchange reserve;
- to be the bank of government and the other banks (lend to government and the banks and manage part of their assets), and
- be responsible for monetary policy.

In most countries the central bank has fighting inflation as its main monetary policy objective. Monetary policy is considered as the most effective means to stabilize the value of money. The reason is that inflation in the long run is determined by the development of the money supply and liquidity, i.e. precisely the variables controlled by monetary policy.

Many economists are of the opinion that the possibilities of the central bank to achieve its goal increase if the central bank is as independent as possible, i.e., if the politicians are not allowed to control the interest rate determination based on short-term, political motives.

3.2.2 A Simplified Central Bank Balance Sheet

For the most part, the assets that make up *bank liquidity* – usually currency and deposits at the central bank – are liabilities of the central bank. Non-bank holdings of currency are a relatively predictable quantity. To influence the quantity of bank liquidity, the central bank must therefore have regard to the remaining elements of its balance sheet. Adjustments in these elements usually reflect, through the balance sheet constraint, a simultaneous adjustment in bank liquidity.

The other main items of its balance sheet are

- central bank lending to banks;
- holdings of government obligations, and
- foreign exchange reserves. (For example, when a bank purchases foreign exchange from the central bank for a customer, the central bank's foreign exchange holdings fall, as does the bank's deposit at the central bank.)

By removing the bank's automatic access to borrowing from the central bank at or below market rates, it is possible to bring the first of these items under control.

Simplified Central Bank Balance Sheet

ASSETS	LIABILITIES
Net Foreign Assets	Reserve money
	Currency issued
Domestic Credit	
Claims on government, net	Bank Deposits
Claims on banks	Other non-government deposits (if any)
Claims on nonfinancial firms (if any)	Capital, reserves etc.

How is *the money supply* determined? There are four different sources:

- (1) The *central bank* manages an important part of the money supply by being in charge of *issuing notes and coins*. Consequently, this part of the money supply is not determined by the interest rate but by monetary policy decisions;
- (2) The activities of the *commercial banks* influence the money supply. Banks may "create" money by starting a lending expansion. The reason is that the money lent is used by the borrowing company or household to buy goods and services and most of this money is deposited by the companies or households who receive the money as payments on their bank accounts. The central bank may, however, limit this "money creation" by banks since it has measures at its disposal to control how much the banks increase their lending.
- (3) The *central bank* can influence the money supply *through market operations*, i.e., buying and selling government bonds. When the central bank buys Treasury Bills or Bonds from the general public, the central bank pays with money, and consequently the money supply increases. The central bank can for the same purpose use "repurchasing agreements" (repos), which means that it buys government securities from the banks and pledges to sell them back after a certain period of time. When the central bank wants to reduce the money supply, it instead sells Treasury Bills or Bonds to the general public or uses reverse repos for the same purpose.
- (4) The fourth source of change in the money supply is the *flow of foreign exchange* to and from abroad. If the inflow from abroad is larger than the outflow, there is an increase in the volume of the country's money supply, and vice versa.

Related to the interest rate level, the *money supply curve* will slope upwards, while the *money demand curve* slopes downwards. The reason is that at a higher interest level people want to move to more interest-bearing assets and hold less money, and vice versa.. The intersection between the supply and demand curves gives the equilibrium interest rate.

A monetary policy that increases the money supply has a tendency to lower the interest rate, and vice versa. *The decision rule for the central bank* is consequently; in order to tighten the economy and raise the interest rate

– sell government securities. In order to expand the economy and lower the interest rate – buy government securities.

The reasoning presupposes, however, that the plans of the central bank are not thwarted by domestic investors and investors abroad, who may compare local conditions with alternative investment opportunities abroad. The more internationalized the economy is, the more difficult it will be for the central bank to manage a fully controlled, own, national monetary policy.

3.2.3 *Direct and Indirect Controls*

Direct methods of monetary policy such as

- liquid asset requirements;
 - interest rate controls, and
 - directed credit
- hinder development of a money market.

Deregulation and establishing a liquid money market create opportunities for innovation in the way banks manage their balance sheets. A central bank seeking to use *indirect methods* to implement monetary policy, such as open market operations, will require an effective interest rate transmission mechanism, which also calls for a liquid money market.

Closely related to improved liquidity management is the policy issue of *co-ordinating government debt and cash management with monetary policy implementation*. These government activities have a strong impact on bank reserve balances and influence the development of primary and secondary credit markets. In the long run, appropriate monetary policy and good debt and cash management will be complementary, although there may be co-ordination problems in the short term.

3.2.4 *Liquidity Control*

Bank liquidity

A key element in conducting effective monetary policy is knowledge of government cash flows. These, like central bank open market operations, also affect banks' reserve balances. Government debt and cash management can co-ordinate with monetary policy by moderating the effect of government expenditures and receipts on the banks' cash balances and by keeping the central bank informed of government cash flows. Money markets will not operate effectively if they are constrained by direct government controls over deposits, interest rates, and lending.

Banks settle their debts with one another and meet cash withdrawals either by drawing on their credit accounts at the central bank or by using currency in their vaults and tills. These assets, representing bank liquidity or the reserves of the banking system, are liabilities of the central bank. Over the longer run, banks can repay their short-term borrowing through the proceeds of maturing loans to customers or by mobilizing additional deposits. The speed and ease with which such actions can be taken depends on the sophistication of the banking system.

When the banking system as a whole is short of liquid funds, there is a generalized upward pressure on interest rates and a tendency for bank credit to be expensive and scarce. Such pressures can be eased by *central*

bank action to provide liquidity to the system; an important function of the central bank is to ensure that seasonal and random influences on liquidity conditions are offset, so that they do not result in corresponding variations in interest rates. On the other hand, the central bank can also take the initiative to ease or tighten liquidity conditions depending on how it perceives a need to stimulate or to restrain aggregate expenditure.

Central bank borrowing facilities

In the past, many central banks provided semi-automatic borrowing facilities to banks at posted interest rates (known as the discount rate, Bank rate, or Lombard rate). These were varied infrequently and effectively placed a ceiling on short-term interest rates. Banks were customarily borrowers from the central bank at or near the posted rate. Because of the political sensitivity of this key rate, upward adjustments were often made too late and in steps that were too small.

As a result, most central banks in industrial countries have moved away from automatic lending facilities and now manage interest rates in a more flexible manner, using a variety of new instruments. Each country has adapted its system of liquidity control in accordance with local conditions. The result is that a great variety of arrangements are in use, though each tends to satisfy certain key requirements.

- There is *no* longer an *automatic availability of borrowing* from the central bank at posted rates; accordingly, short-term interest rates tend to be more flexible than in the past.
- Most systems still have an *upper and lower buffer* to prevent undue interest rate gyrations in case the day-to-day instruments for influencing interest rates are unable to cope with a big surge in the demand for liquidity or in the availability of liquid funds.
- The *fluctuations of interest rates* provide much information to the central bank to help it gauge market conditions.
- For open economies operating a *pegged exchange rate* system, the regime often provides for an automatic stabilizing response of short-term interest rates to foreign exchange flows.

Liquidity management

Liquidity management in most industrial countries takes place today in a much more developed and competitive money market than was the case only a few years ago. While other policy and technological changes have also played a part in developing money markets, it can be said that the more flexible techniques of monetary management have required and encouraged these developments.

The economy has been well served by a deeper money market, which allows growing numbers of corporate borrowers direct access to short-term funds without having to pay for bank intermediation costs. The deeper money market has also ensured a more competitive and probably less costly system of bank intermediation. Firms that are allowed to hold certificates of deposits or commercial paper bearing market rates of interest will not settle for below-market rates on their deposits. Developing countries can also benefit from such reforms (and some already are) as they, too, move towards refined techniques of monetary management.

In particular, deeper money markets allow banks to economize on liquidity holdings.

Between the floor and the ceiling buffers, the central bank usually has a variety of other instruments to influence bank liquidity conditions. Many of these involve quantity rather than price (interest rate) decisions by the authorities. For example, it is normal for central banks to make projections as to the liquidity needs of the system over a period of one month or more and to make interventions to add or drain the amount of liquidity that seems, on average, appropriate for that period. Among the *liquidity management instruments* used are

- reversed transactions in domestic securities and foreign exchange,
- transfers of government deposits, and
- outright purchases and sales (i.e., open market operations) of domestic securities and foreign exchange.
- shifting government deposits between commercial banks and the central bank, which is another tool by which the authorities can influence liquidity conditions. A rise in commercial banks' share of government deposits increases bank liquidity just as do expansionary open market operations.

The move from

- a system of monetary management where the central bank provides liquidity on a bilateral bank-by-bank basis, as with the discount window,
- to one where the focus is on managing the overall quantity of liquidity, requires the development of markets in which the banks and possibly other participants can compete for their liquidity needs.

Reserve requirements

If central bank *management of bank liquidity* is to be effective in influencing monetary conditions generally, it is essential that banks do meet their cash obligations, including the maintenance of any reserve requirements. Unauthorized overdrafts that arise from the clearing of checks must be automatically penalized by the central bank with sufficient severity to make such overdrafts quite exceptional. An additional merit of reserve requirements is that they can be adjusted to produce desired changes in liquidity. They can be raised in times of unexpectedly strong capital inflows to effect a broad-based mopping up of excess bank liquidity, thereby sterilizing the domestic impact of the inflows. Apart from such occasional circumstances, however, reserve requirements are often considered too blunt an instrument to be used for varying liquidity conditions.

Reserve requirements were originally introduced in many countries as a *prudential measure* to ensure that banks would have sufficient liquidity on hand to meet unexpected deposit withdrawals. For that reason, they were expressed as a fraction of deposits. For monetary control purposes, there is no reason why they could not be expressed as a proportion of credit. Especially, if credit is considered a more relevant intermediate objective of monetary policy.

The assets eligible to satisfy *reserve requirements* are usually *defined* to include specified classes of deposit at the central bank and possibly special government bills. Some countries also include vault cash. Most countries do not include instruments that bear a full market rate of interest, and therefore the requirement represents a distorting tax on financial intermediation. *Accordingly*, it is best to limit the size of reserve requirements and to link the rate of remuneration on required reserves to the market rate.

3.2.5 Money and Bond Markets

Interaction between money and bond markets

The capital market – the bond market as well as the money market – is of vital importance to the development of the economy. The financial market links savings surpluses in certain sectors to deficits in other sectors. By doing this, the financial market establishes an interest level which has large implications for the cost of investment and construction. The public sector – through its borrowing and lending – plays a central role in the financial market. Especially, this works through the consequences of a budget deficit or surplus and its financing in the financial market.

The money market is a cornerstone of a competitive and efficient system of market-based intermediation. Normally it should be in good working order before a government bond market is developed. The money market stimulates an active secondary bond market by reducing the liquidity risk attached to bonds and other term financial instruments and assists financial intermediaries in managing liquidity risk. It makes it easy for financial institutions to cover short-term liquidity needs. Further, it makes it less risky and cheaper to warehouse bonds for on-sale to investors and to fund trading portfolios of bonds.

Trading in forwards, swaps and futures is also supported by a liquid money market. The reason is that the certainty of prompt cash settlements is essential for such transactions. The money market serves as the medium for government cash management and provides the first link in implementing monetary policy using indirect instruments. Money markets are essential for conducting indirect, market-based monetary policy operations and for providing the liquidity necessary for a market in government bonds and in private sector securities.

The money market will not develop if banks have inadequate incentives to develop treasury capacity, which is the ability to actively manage liquidity and interest risk. Three issues that particularly affect the development of money markets in developing countries are

- lack of treasury capacity in banks;
- lack of multilateral trading, and
- weak banks.

An IMF and World Bank consensus on the Importance of Developing Domestic Bond Markets

The World Bank and the IMF agree that the development of domestic bond markets deserves high priority on the agenda of financial sector development. On the one hand, bond markets are essential for a country

to enter a sustained phase of development driven by market-based capital allocation and increased avenues for raising debt capital. On the other hand, the central position occupied by domestic bond markets is markedly increasing the resilience of a country's financial system. It is also insulating it against external shocks and contagion. Further, access to international capital markets is established.

Since the recent eruption of wide-spread financial crises in 1997, the World Bank and the IMF have dedicated substantial human and financial resources to efforts geared towards restructuring the financial sector and reducing financial vulnerability. A key component in their efforts has been strengthening capital markets, in particular domestic bond markets. The importance of government bond markets in catalyzing the growth of overall bond markets is recognized and accepted. A recently designed Handbook (IMF and the World Bank, 2001) dealing with government bond markets spearheads the work of IMF and the World Bank in this area.

The reality of financial globalization

As national economies become increasingly open and interlinked with a market-oriented global financial architecture, it is imperative that the domestic financial sectors become market-based as well. Many economies which suffered during the Asian financial crisis were borrowing from international debt markets, but were running semi-controlled local financial sectors. This weakness was costing them dearly.

3.3 Effects of Monetary Policy

3.3.1 Influence on Inflation

The main tasks of the central bank are to guard the price stability as well as financial stability. As explained above (page 10) price stability supports financial stability, and vice versa. Below the discussion focuses on the inflation issue. Financial stability is elaborated on in chapters 4 and 5.

The central bank's weapon in fighting inflation is controlling the shortest money market interest rates. But it takes time before an interest rate change influences the inflation. Therefore, the central bank has to prepare thorough and long-term inflation forecasts.

Suppose e.g., that the central bank is afraid that inflation will rise above the targeted level. This motivates a tightened monetary policy. In order to achieve this, the central bank sells government securities to the banks. When government securities are sold, liquidity is withdrawn from the economy, and the interest rate in the money market rises. This happens in several steps. First the repo interest rate of the central bank rises. Then follows increasing short money market interest rates, which in turn affect:

- asset prices, e.g., shares and real estate will fall;
- households who borrow at flexible/variable interest rates. They will be hurt by higher interest costs and will have to reduce their consumption;
- corporations' financing costs, which will rise. The willingness to invest will be reduced;

- demand, which will fall and lead to a reduced will to employ. The unemployment will increase, and consequently the rate of wage increases will be reduced;

As a consequence of all this, inflation pressures will be diminished. The central bank may instead be of the opinion that there is room for stimulating the economy, the reason being that it forecasts a slow-down in inflation. Then the central bank will do the opposite, i.e. lower its repo interest rate through buying government securities. This will lead to lower market interest rates, which will stimulate private consumption and investment. A prerequisite for this outcome is that the central bank's lowering of the repo interest rate is trustworthy and is accepted by the investors.

3.3.2 *The Timing Issue*

It takes time before a central bank's increase of its steering interest rates has achieved its full effect on inflation. The whole process takes more than a year. This means that the central bank has to manage its monetary policy with good planning ahead. Interest rates changes have to be made "beforehand". This means that they can be quite debated. Especially, if different expert judges have different opinions regarding what future inflation trends (a couple of years from now) really look like.

3.3.3 *Financial Depth*

Financial depth is critical as a prerequisite for a well-functioning financial intermediation, including long-term finance, as well as an effective and efficient monetary policy. Especially, diversifying and deepening the financial system will increase the resilience of economies and financial systems to external and internal shocks. The level of financial depth (Popiel, 1994) is approximated by the ratio of M2 or M3 to GDP. M2 is generally defined as M1 (that is, currency in the hands of the public + demand deposits) + time and savings deposits. M3 is defined as M2 + short term certificates of deposit and similar financial instruments.

In developing countries financial depth is determined by four types of factors:

- macroeconomic;
- institutional;
- monetary, and
- financial.

Financial deepening and increased savings are often but not necessarily two different aspects of the same phenomenon. A greater use of interest-bearing financial instrument reflects an increase in domestic financial savings. This leads to (and requires) financial deepening, since it calls for

- more sophisticated and diversified markets;
- a wider range of financial instruments, and
- a more developed institutional infrastructure.

There is well established empirical evidence relating financial depth in developing countries to

- the per capita income. Empirical evidence shows that a 1 percent increase in per capita income is in developing countries associated with an approximately 1.5 percent increase in the indicators of financial depth;
- the level of transactions in the economy;
- the degree of development of the financial infrastructure;
- the rate of return on financial assets, and
- the exchange rate policy (see e.g. Sing, 1992).

Further empirical evidence suggests that in an environment of high inflation, real monetary balances contract. High inflation usually results in a flight of domestic financial assets into foreign financial assets or real assets.

The deepening of financial systems occur largely through the expansion of the range and use of interest-bearing instruments, together with the development and diversification of financial markets and financial infrastructure.

3.3.4 The Foreign Exchange Flow Constraint

A quick increase of liquidity at a given level of production causes a *risk of an outflow* of foreign exchange; the money not only moves the prices upwards but it may also "flow out of" the country. This is, among other things, a consequence of the fact that a policy which increases the money supply aims at lowering the interest rate. And if the interest rates in a country are lower than in other countries, there is a risk of easily mobile capital searching its way out of the country; investors move their assets abroad in order to receive the higher interest rate there.

An outflow of foreign exchange influences in turn the value of the currency. If the country has a *variable exchange rate*, the outflow causes a depreciation of the currency, i.e., a falling exchange rate.

Outflows of foreign exchange may also threaten a *fixed exchange rate*, that is if a speculation against the currency is getting started. A diminished demand for a currency leads to a downward pressure on the exchange rate. Many people may want to move their currency holdings to other currencies. They do so partly in order to avoid losses. Partly they are maybe hoping that after a devaluation they will be able to change back to the national currency and by so doing getting more of this currency than the original holding. When more and more people desert a currency and speculate in a devaluation, an undesired devaluation may be forced through.

A depreciation of a variable exchange rate or a devaluation of a fixed exchange rate in turn raises the import prices and thereby support a general price increase.

3.3.5 Potential Side-Effects

An important conclusion is that a too expansionary monetary policy aiming at achieving low interest rates may have undesired side-effects. These could take the form of inflation expectations, a weakened exchange rate and rising bond interest rates.

3.4 Co-operation between Fiscal and Monetary Policy

3.4.1 *The Need for Co-ordination*

Problems with large budget deficits have nowadays caused most economists and politicians to be sceptical to the old Keynesian belief that it would be possible to fine-tune the economic development over the business cycle with the help of fiscal and monetary policy. To use an expansionary policy with increased budget deficits against unemployment risks leading to inflation or interest rate increases, with accompanying negative effects on the country's competitiveness and investments. To use contractionary policy against inflation, on the other hand, causes risks of unemployment.

The *conclusion* is, in more general words, that *fiscal and monetary policy should work in the same direction and support each other*. In practice, however, the central bank is often the cautious, "careful" institution, seeing as its task to brake and restrain, while politicians often mainly are inclined to spend more. This is the reason why many economists want the central bank to have a certain independence, in order to better look after the value of money.

3.4.2 *Government Debt Managing*

When the government has a large budget deficit and is borrowing heavily in the financial market, this influences both interest rates and credit volumes. This in turn affects the rest of the (macro) economy. The influence on the financial market and the economy is, of course, also large when the government has a large budget surplus and as a consequence lends a lot of money (and/or pays back its debt).

What is crucial is not only the size of the deficit (or surplus), which determines how large the total government borrowing (or lending) will be, but also how the borrowing (or lending) is managed and organized. For this reason it is consequently important that the analysis of the economic policies include

- not only the effects of fiscal policy;
- but also the effects of monetary policy, as well as
- government borrowing (or lending) policy.

Government debt policy refers to the management of government debt; how loans are taken up and renewed at different interest rates and maturities. The organizational address varies from country to country

- from the central bank;
- a separate authority;
- to the Ministry of Finance.

The form of *co-operation between monetary policy and fiscal policy* varies from country to country. Some countries have established a firm separation of monetary and fiscal policy in that they prohibit any lending from the central bank to the government. Less rigorous rules in other countries establish quantitative limits on such lending. Where lack of fiscal restraint presents serious risks to monetary stability, such rules can have merit, despite their arbitrary nature. In most countries, however, the

central bank has to cope with providing an environment in which the financing of the government deficit is achieved while maintaining as much monetary and general economic stability as possible.

3.5 Monetary Policy in an Open Economy

3.5.1 Interest Rate Differentials

If there are no regulations of the currency, and if the international credit markets react quickly on interest rate differentials, then *interest rate differentials* between countries *will stimulate flows of foreign exchange*. These, in turn, tend to level these differences or cause such exchange rate changes that investments in different currencies bring similar return. This depends on the fact that investors (those who lend money) request a certain return on their capital. If the capital is mobile, the return, after taking interest rate levels and currency changes into account, will have to be approximately the same in a small open economy as it is in the most important competing countries.

With a simplified expression:

The interest rate in one country = the interest rate abroad + expected exchange rate change.

When investing money, investors will compare interest rates at home and abroad. On top of that they will take into account the expected exchange rate development. If the value of a currency is expected to increase, investments in that country will be more attractive, and may compensate for a lower interest rate; and vice versa, if the value of the currency is expected to fall there has to be a higher interest rate to compensate.

The exchange rate regime – being fixed or variable – will consequently affect the room for manoeuvre of a country's monetary policy.

3.5.2 External Flows and Monetary Policy

Different foreign exchange regimes

Conceptually, a *freely floating exchange rate* means that there are no flows into or out of the central bank's foreign exchange reserves. In the polar opposite case of a *rigidly fixed exchange rate*, the central bank has no freedom to control its foreign exchange reserves, as it has agreed to accept or provide foreign currency against domestic funds on demand. Between these two extremes there exist a variety of different approaches to exchange rate management, which generate a variety of implications for the operation of monetary policy.

A free float

If a country has adopted a *free float*, it cannot rely on exchange rate policy to give it a stable price level. Monetary policy – particularly limiting the nominal expansion of bank liquidity – will be the key to controlling inflation. In these circumstances, a stable interest rate may be the enemy of price stability, particularly if inflationary expectations build up and result in more and more borrowing from the central bank at the – now too low – stable interest rate.

An *active interest rate policy* in a floating exchange rate regime has a *double effect on demand* conditions in the economy. By acting to raise interest rates,

the authorities increase costs and lower domestic demand directly. The resultant capital inflows serve to appreciate the currency, thereby also reducing external demand. Thus, the number of sectors exposed to the first round of impact of monetary policy is increased.

A fixed exchange rate

A *fixed exchange rate*, by contrast, should ensure a good degree of *price stability*, depending, of course, on what currency or basket has been adopted for the peg. But the exchange rate is fixed only as long as the authorities have *sufficient reserves or foreign borrowing capacity* to defend it. An inappropriately high level of domestic liquidity expansion (resulting, for example, from the central bank financing much of a high budget deficit), will result in a steady drain on reserves and, eventually, a forced abandonment of the peg. This will perhaps be precipitated by a well-judged attack on the currency by speculators.

A *fixed exchange rate* can also be *vulnerable*, even if monetary policy is not systematically misaligned in this way. For example, spontaneous *short-term capital* inflows, if not sterilized by offsetting action by the central bank, may relax domestic credit conditions so far that wages and costs generally get out of line. This weakens the competitive position of the economy and results in an unsustainable drain on reserves over the longer run, especially if the capital flows are reversed. Prompt action by the central bank to sterilize some of the inflow may be necessary to prevent this cycle, which has been observed in several developing countries as well as in the smaller developed countries.

There can also be *spontaneous speculative attacks* on a fixed exchange rate – although the onus must be on the authorities to prove to their own satisfaction that the flows are spontaneous and do not reflect an underlying weakness in the economy. Few countries have sufficient resources to ride out such unwarranted speculative attacks without adjusting policy. The normal action is to allow the drain on domestic liquidity, which such an attack produces, to raise interest rates – dramatically if necessary. This can make unsuccessful speculation so costly that the attack is quickly choked off.

However, *the impact of the balance of payment on monetary conditions need not be destabilizing*. Indeed, it has long been observed that a fixed exchange rate country whose competitive position deteriorates will experience a current account deficit. If not sterilized, this deficit will tighten domestic liquidity conditions enough to lower domestic demand, divert the production effort into exports, and improve competitiveness.

3.6 Special Developing Countries Issues

Detailed *recommendations* for the application of monetary policy instruments to developing countries include a number of key messages to be highlighted:

- *Indirect methods* of monetary control require a certain degree of interest rate volatility. The challenge for the authorities is to act promptly and vigorously even when unpalatable interest rate increases are needed. They must also ensure that their institutional set-up makes provision for them to lower interest rates, when that is appropriate.

- The successful central bank will *listen to the market as well as guiding it*. Freed from the constraints of quantitative controls, financial markets will often signal inflationary pressures or an impending slump, thereby assisting the formulation of monetary plans and policy.
- The stability of *money demand relationships* cannot be relied upon in developing countries, partly because there is not sufficient historical experience with liberal markets on which to base forecasts. Several experts have noted the difficulties with intermediate targets even in industrial countries with more experience and the result that monetary targeting no longer holds the position it once did. Accordingly, it may be necessary for developing countries to concentrate directly on targeting foreign exchange reserves rather than on choosing an intermediate target such as the quantity of money. Some experts advocate this approach, though observing that a tight monetary policy can result in private capital inflows rather than reducing the current account deficit.
- There may be *one-off portfolio adjustments* following financial market liberalization and the removal of quantitative controls. The authorities must be prepared for these adjustments, often involving a greater expansion of credit demand than of deposit supply. The inflationary consequences may be ameliorated by appropriate interest rate levels or, depending on circumstances, capital inflows.
- *Optimal functioning of indirect methods* requires the development of new markets; these in turn enhance the efficiency of financial markets and their ability to serve the economy, including its investment needs. *The objectives of financial market development and monetary policy thus go hand in hand.*
- Also, it is useful to provide some *hint of caution about the risks for central bankers* in being too doctrinaire about market-oriented policy instruments. Emergencies can arise that do require old-fashioned non-market-clearing solutions.

Finally, *shifting away from direct means of controlling monetary policy is by no means universal in its appeal*. Direct controls are simple to operate. They seem to offer a sure handle on overall credit or money growth. As noted by several observers, moving away from direct controls often involves a fundamental reorientation of central bankers and government officials, not only in regard to directed credit but also concerning the financing of government debt. However, monetary officials in a variety of countries have found that there is no fool-proof method to guarantee the achievement of any overall monetary target.

Bank-by-bank credit ceilings suffer from the same limitation; eventually, nonbanks arise to escape credit limits, and banks have every incentive to evade controls. Moreover, such ceilings limit competition and, by choking off innovation and prompting excessive holdings of liquidity, can curtail growth both in the financial sector and in the rest of the economy.

Not all countries are in a position to apply immediately the experience already gained by industrial countries in operating indirect methods of monetary control. It can, however, be expected that more and more monetary authorities will soon begin to follow the lead of several Asian countries, in particular.

4. Financial Policy

Trends in Developing Countries²

4.1 General Trends

4.1.1 *Financial Sector Development in Sub-Saharan Africa*

The countries of sub-Saharan Africa (SSA) have witnessed a distinct improvement in their economic performance in recent years, with increasing growth rates, declining inflation, and narrowing financial imbalances. The improvement is attributable in large part to the implementation of sound economic, fiscal and financial policies, including policies to liberalize trade and improve the investment climate. In addition, these countries embarked on fundamental structural reform.

To build on this progress, it's a general IMF/World Bank view that SSA countries need to

- sustain their adjustment efforts;
- further strengthen economic and financial policies, and
- complete the building of a market-oriented economic framework.

At the same time, globalization is proceeding rapidly, posing further challenges, as well as opportunities, for these countries. Foreign assistance, particularly official development assistance flows, on which many of the countries have so far relied, is on a long-term declining trend. Therefore, if SSA countries are to attain higher per capital incomes in the future, they must make further efforts to attract and retain needed private capital – both domestic and foreign in order to accelerate growth.

Many of these countries are working to meet this challenge. To support their efforts, the international community has expressed its willingness to enter into a partnership with these countries through *the Africa Initiative*. This is directed at

- promoting trade and investment;
- mobilizing global private capital flows, and
- building up human resources.

The IMF, the World Bank, and other donors could make an important contribution to the Africa Initiative. To determine the nature and extent

² The text below is based mainly on the following titles listed in the Bibliography (Appendix 2): De Soto, 2003; Griffith-Jones, Ocampo & Cailloux, 1994; Huang & Wajid, 2002; Häusler, 2002; IBRD, 2002; IMF, 1998; Popiel, 1994.

of such a contribution, IMF's Monetary and Exchange Affairs Department (MAE), has conducted a study of financial sector issues in 32 selected SSA countries. The study reviews the progress made by these countries in reforming their financial sectors and identifies areas in which further progress is required. The presentation below is based on some of these results.

4.1.2 Capital Markets and International Capital Flows

Capital markets, i.e., markets dealing in longer-term financial contracts, are *emerging* in most countries in SSA. 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 macroeconomic 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 1960s in order for governments to provide finance for long-term development. 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 capitalized and subject to political interference*.

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 *privatization programmes* which require large amounts of risk capital and efficient secondary markets in corporate assets (shares).

4.1.3 Private Capital Flows to Recipient Countries in sub-Saharan Africa

A number of studies have investigated the relationship between *economic growth at the aggregate level and inward foreign direct investment (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 "receiver competence". There are, however, a number of crucial conditions for FDI still lacking in the region, including

- (1) political instability;
- (2) debt overhang and shortage of foreign exchange;
- (3) inadequate institutions, legislation and financial systems;
- (4) low levels of education and skills;
- (5) small domestic markets;

- (6) poor infrastructure, and
- (7) low reliance on privatization and debt equity swaps to attract FDI.

4.1.4 The Role of the State in Financial Markets

In virtually all countries in SSA, 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, 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 process under way in most countries in SSA has 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.

4.1.5 Transition to Indirect Monetary Management

Indirect monetary management requires a stable macrofinancial environment. The process of transition itself is likely to increase the variability of monetary parameters. Interest rates will become more volatile, and new, indirect ways of monetary management are likely to lead initially to undershooting or overshooting of new intermediate and operational targets. The result is possibly wider fluctuations in credit, monetary aggregates, or interest rates. Moreover, the public sector financial situation must be under control and sufficiently stable to be sustainable in the long term. Recent studies have shown that in SSA, the budgetary situation is a dominant factor in monetary management.

The financial system must also be in good health. If a substantial part of the system is in financial distress, this will likely undermine efforts to move toward indirect monetary management. Markets such as interbank and money markets do not operate properly under conditions of major financial distress. Moreover, because of the added difficulties of predicting the level of money supply and keeping it under control, the transition is more difficult. In SSA, transition from direct to indirect controls also requires the development of new financial markets. There must be a minimum market base – at least an interbank market and embryonic money markets – and competition must be present in these markets and in the financial system at large.

4.1.6 Control of the Money Base

The central bank must be free to manage its balance sheet in a way that allows it to influence the elements of the money base that

- can be controlled, and
 - the other elements whose movements can be offset.
- Moreover, it has to have
- the appropriate legal;
 - regulatory and enforcement powers, and
 - an information system that provides timely data on bank reserves and money conditions.

Finally, the staff of the central bank has to have the skills needed to implement its reserve management objectives through day-to-day operations in the money markets.

4.1.7 Co-ordination of Monetary and Fiscal Policy

Especially in SSA, where the government's budgetary situation is a dominant factor influencing monetary management, indirect management requires the close co-ordination of fiscal and monetary policy so that the public sector's deficit financing requirements are consistent with the objectives of monetary policy.

Further, there must be a close monitoring of fiscal out-turns, in particular if their predictability is weak. Staff from the central bank and the ministry of finance must be able to work effectively together.

For all these factors to play their role in reserve management, there must be

- a mechanism through which changes in monetary policy are transmitted to the real economy, and the mechanism must be clearly identified by policymakers and monetary managers.
- competition in financial markets, which tends to produce the most efficient channels.
- flexible interests that respond to market signals, which in turn are essential to the financial market competition.

Moreover, to ensure that the promotion of competition does not subject the financial system to unwarranted systemic risk, financial supervision must create the prospects that major financial failures will be minimized.

Finally, there must be an efficient monetary programming associated with an effective decision-making process to support and guide indirect monetary management.

4.2 Financial Sector Reform

4.2.1 The Financial System Prior to Reform

By the mid-1980s, *financial systems* in most SSA countries were *manifesting signs of* weakness and vulnerability primarily because of

- deteriorating macroeconomic conditions and also because of
- political interference in the operations of financial institutions;
- negative real interest rate policies, and
- directed credit policies.

These financial systems were compounded by *structural weaknesses*, including

- the absence of an appropriate legal framework to grant independence to central banks in the pursuit of price stability;
- weak operating procedures and the absence of effective instruments for market-oriented monetary management;
- ineffective and noncompetitive financial market structures;
- an inefficient bank regulatory and supervisory environment, partly caused by a lack of supervisory autonomy and capacity;
- inefficient payments systems;
- the absence of an effective legal mechanism for debt collection, and
- inadequate accounting standards and reporting, and disclosure requirements.

These weaknesses limited the financial system's efficiency and its ability to perform its financial intermediation function.

Historically, SSA countries placed *great emphasis on developing and protecting the real sector*, with the financial sector having only an ancillary role. Most countries strongly believed that they could support their development objectives through selective credit allocation mechanisms. As a result, governments became directly involved in the operations of the financial sector and even set up financial institutions (mainly commercial and development banks) to ensure that the monetary and financial systems contributed to the achievement of the development goals. These institutions were used mainly as vehicles to direct credit to *specific sectors* of the economies. Banking resources were used to finance the government *budget deficit* and to provide financing for state-owned companies.

Credit to the private sector was crowded out and rationed, and interest rates were controlled at below the market-clearing rate – often at negative rates in real terms. Most countries also introduced *price controls and foreign exchange restrictions* and rationed many goods and services, including foreign exchange. Excessive controls encouraged the development of *parallel markets*, which led to the hoarding of foreign currencies.

The *debilitating effects of these trends* on the development of the financial systems of SSA countries during the 1970s and 1980s may be characterized as follows:

- First, *the growth of these economies* was not commensurate with the level of investment, largely because of low efficiency in the use of capital, which was mostly provided to poorly managed state-owned companies;
- Second, the bias of *directed credit* in favour of selected sectors, particularly the agricultural and mineral, resulted in an overconcentration of credit in these sectors, thereby increasing the banking system's vulnerability to risks. Owing to deteriorating terms of trade, bad weather, and mismanagement, many of these directed credits became nonperforming loans. In addition, the ability to borrow at cheap rates encouraged less productive investments. Those who borrowed for projects with low financial returns could not repay their loans. In other cases, borrowers willfully defaulted because many believed creditors could not force court action against those considered to be in priority sectors. The distorted allocation of resources and erosion of financial discipline left intermediaries unprofitable and, in many cases, insolvent;

- Third, *macroeconomic instability*, primarily originating from fiscal deficits, compounded the difficulties that the financial systems faced. Against the background of rising fiscal deficits, most governments resorted to borrowing from central banks because the domestic financial markets were too shallow to meet the financing requirements. This resulted in high inflation. Volatility in economic growth and rising inflation made it even more difficult for banks to assess borrowers' creditworthiness, leading to the granting of more bad loans. In particular, volatility in inflation rates led to asset price bubbles that have proved to be extremely detrimental to the asset portfolios of financial institutions;
- Fourth, *the negative real interest rates* that resulted from interest rate ceilings undermined the allocative efficiency of the financial system, and led to capital flight. In addition, the artificially low lending rates caused excess demand for credit, thereby forcing financial institutions to ration loans – sometimes favouring borrowers with projects that had lower rates of return;
- Fifth, *the misalignment of the real exchange rate* in many SSA countries arising from maintaining overvalued currencies in real terms for a long time proved detrimental to some sectors and biased the economy toward import dependency;
- Sixth, *the use of direct credit and interest rate ceilings* constrained liquidity management by banks, resulting in disintermediation and reducing the client base and profitability of the banking system. In addition, it did not encourage central banks to develop market instruments and build capacity for their use.

With these circumstances at play, *the banking system* in these countries effectively *failed* to serve as a pivot for the implementation of monetary policy. With banking systems virtually in crisis,

- the financial intermediation process suffered;
- the efficiency of the payments systems deteriorated,;
- financial and borrower discipline eroded, and
- banks ceased to be a safe haven for savings, distorting resource mobilization and allocation.

Consequently, economic policy management and performance were undermined, thereby adversely affecting real incomes and prices.

4.2.2 Implementation of Economic Reform

Against the background of the deteriorating economic and financial situation, by the late 1980s and early 1990s, SSA countries had embarked upon a policy of adjusting their economies and dismantling the controls and restrictions that had become institutionalized. This policy was largely instituted within the framework of IMF-supported SAF/ESAF (Structural Adjustment Facility/Enhanced Structural Adjustment Facility) programmes and World Bank-supported SAC and SAL (Structural Adjustment Credit/Loan) programmes. The overall objective was to achieve noninflationary, private sector-led growth within a market-based economic system.

In the context of the overall adjustment programme, a large number of SSA countries also undertook structural reforms of the financial sector. In general, these reforms included

- granting central banks more autonomy in conducting monetary policy;
- liberalizing interest rates and eliminating administrative allocation of credits;
- instituting the transition from direct to indirect monetary policy implementation;
- restructuring banks to restore their solvency;
- developing financial markets; and
- improving infrastructures, including bank supervision, and accounting and auditing practices.

4.2.3 Progress with Reform

Improvements in the real economy and the financial sector

With the introduction of overall reforms, including in the financial sector, SSA countries as a whole have made significant strides in adjusting their economies. As a result, growth is beginning to gain momentum and per capita incomes are once more on the rise. Even though the period of adjustment has been relatively short, these countries as a group, have made significant progress on most macroeconomic indicators.

Equally encouraging results are emerging from the financial sector. For one, monetary authorities are becoming more effective in controlling monetary aggregates. Intermediation has increased, with claims on the private sector as a percentage of GDP rising from the prereform level of 15.1 percent to 18.9 percent at the end of 1996, while net claims on government as a percentage of GDP have decreased from 5.2 percent to 4.1 percent. The structure of the financial system itself is changing rapidly; less than 40 percent of banks are publicly owned compared with more than 50 percent during the prereform era.

Domestic monetary operations

Notwithstanding these trends, progress with financial sector reform has been varied and uneven. While some countries have progressed faster and further than others and are gradually transforming the financial sector and their economies, others have yet to make significant headway with overall reforms. In like manner, considerably more success has been achieved in some areas of reform than in others, even within the same country.

In terms of performance in the key areas of the financial sector, SSA countries have made considerably more progress in the area of domestic monetary operations – that is, in establishing market-based monetary policy instruments and procedures – than in any other area of financial sector reform. In all countries except Angola, Ethiopia, and Lesotho, where some restrictions remain, interest rate and credit policies have been fully liberalized, and the central bank is increasingly relying on some form of open market operations. While open market operations prevail, however, trading in government securities in primary markets

constitutes the major element of these operations. Interbank markets, though being promoted, are still limited, and secondary markets are still only embryonic or virtually nonexistent.

Foreign exchange arrangements

Together with domestic monetary operations, most SSA countries have also made tangible progress in liberalizing the external sector current account as well as in developing foreign currency interbank market activities, including the opening of foreign exchange bureaus. In terms of foreign exchange arrangements, a larger number of countries today maintain unpegged arrangements than in 1975, when the overwhelming majority of countries maintained pegged arrangements.

Although some progress has also been made with the liberalization of capital account transactions, most countries are still considered restrictive because they maintain controls over capital receipts and outflows, including investment liquidation. Controls over portfolio investments, within the limits of the existing capital markets, appear to be discouraging private capital flows.

Banking supervision

In recent years, all countries have also made considerable progress in strengthening banking supervision activities. Although not all the countries have promulgated basic legislation granting full autonomy for supervision to the central bank, many have adopted or are adopting prudential regulations that are basically in line with the Basle Committee's Core Principles. In addition, all countries conduct both off-site monitoring and on-site inspections of banks and, in some cases, other financial institutions. Moreover, to reinforce sound banking systems within regions, they are pursuing regional co-ordination and harmonization of supervision policies. Two significant examples are:

- (1) the arrangements under the *East and Southern Africa Banking Supervisors Group*, where the governors of the central banks of 16 countries have committed themselves to co-operating and co-ordinating development on matters regarding banking supervision, and
- (2) the establishment of the two banking commissions by *the CEA countries* as supranational supervisory bodies whose authority transcends loyalty to any single national interest.

Needs for further improvements

Despite the progress that SSA countries have made in the aforementioned areas, a number of other key functional areas requires further and urgent attention. In the area of central bank autonomy, over 75 percent of the sampled countries still confer only limited and selective autonomy on their central banks in the conduct of monetary policy; only three countries – Botswana, Kenya, and South Africa – have central banks with significant autonomy. A conducive legal and regulatory framework is critical to the development of the financial sector.

Other areas in need of improvement are payments system development and central bank accounting and auditing. The inefficient payments system and the high level of reserve requirements as the main tool

of domestic liquidity management are some of the major causes of the large spread in interest rates observed throughout SSA countries and are also the main reasons for the limited credit expansion in the private sector. The accounting and auditing of financial institutions – which are crucial for effective banking supervision – also need work. Finally, almost all the countries need to modernize or replace obsolete information technology and data management systems.

Long periods of adjustment needed

After nearly a decade of experience, there is growing consensus that financial reforms in SSA 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.

4.3 Further Reform Needs

4.3.1 Problem Areas in Financial Sector Development

SSA continues to face *challenges* that will need to be overcome rapidly if the financial sector is to play its part in fostering growth and raising per capita incomes in these countries. The most relevant ones are highlighted below:

- Most of the countries continue to provide only *limited autonomy to central banks* to perform appropriate monetary and supervisory functions. Government interference in credit extension, bank licensing, and supervision encroaches on the fulfilment of the main mandates of the central bank – that is, maintaining price stability and ensuring the soundness of the financial system.
- The financial sector still suffers from a *lack of competition* created by the still-dominant position of large government-owned banks, and the lack of a level playing field continues to discourage the entry of private and foreign banks.
- The large share of *nonperforming loans* on the balance sheets of the largely government-owned commercial banks impedes the development of interbank markets because sound banks do not want to deal with weaker banks.
- The *absence of* a complete array of *monetary instruments* and a dearth of *expertise* constrain the ability of central banks to deal with the excess liquidity created by government expansionary policies.
- The large share of nonperforming loans, the crowding out of the private sector, the lack of competition in the financial sector, and high administrative costs, as well as high reserve requirements and inefficient payment systems are at the root of the *large spreads* between deposit and lending rates.
- The crowding-out effect of government borrowing pushes *the interest rate structure* upward and discourages borrowing for long-term investment.
- The *regulatory framework for supervision* is not entirely satisfactory, and its implementation not always effective. The authorities are tardy in dealing with insolvent financial institutions. Loan recovery is also hampered by bottlenecks in the judicial system.

- The *uncertainties* surrounding the *political and economic situation* of some countries have an impact on investor preference for short-term speculative investments and discourage savings and long-term credit expansion.
- The *inefficiency of payments systems* hinders financial sector development, keeps payments system risks high, and hampers the transmission mechanism of monetary policy.
- The constraint imposed by the *dearth of welltrained and qualified nationals* limits the formulation and implementation of sound monetary policy.

4.3.2 Areas for Further Reform

To meet these challenges, SSA countries will have to intensify their efforts to maintain macroeconomic stability and accelerate structural reforms. In other words, they must first build a macroeconomic, regulatory and institutional environment that fosters domestic savings and attracts private capital and must then channel these resources into long-term, broad-based, and sustainable growth.

The lessons that have emerged from the experiences of countries in Europe, Latin America, and Asia indicate that the first steps would be to get the fiscal deficit under control and establish macroeconomic stability. Clearly, reforms cannot proceed effectively against the background of an unstable macroeconomic environment. In addition, given the dual relationship between macroeconomic stability and financial sector development, macroeconomic stability must be accorded high enough priority in the reform of the financial sector if the two are to catalyze and reinforce each other.

With regard to *structural reforms*, further measures are generally required in a number of areas:

- *Legal and Regulatory Framework.* To attain a suitable level of autonomy for central banks, governments would have to promulgate necessary central bank legislation;
- *Development of Market-Based Financial System Infrastructure.* Issues to be addressed include getting fiscal policy under control, restructure banks and strengthen the soundness of the financial sector, acquiring the means and developing instruments to absorb excess liquidity, and modernize the payments system;
- *Foreign Exchange Operations.* Despite the progress made in external liberalization, further efforts are needed to improve the policy mix with respect to macroeconomic balance, bank soundness, and political stability. To liberalize capital markets without being sufficiently prepared in terms of structural reforms and financial soundness could be counterproductive;
- *Banking Supervision.* As economic stabilization has progressed in SSA countries and inflation rates have come down, there is a corresponding need for commercial banks to strengthen their balance sheets, increase provisioning for nonperforming loans, and strengthen their credit and market risk analysis. In this connection, firm, timely, and effective supervision is required to ensure that these imperatives are adhered to. In this regard, these countries must make greater efforts to comply with the basic supervisory standards relating to prudential

regulations guided by the Basle Committee's Core Principles for banking supervision and further strengthen examination procedures, including on-site inspections and off-site surveillance, that are capable of identifying weaknesses.

4.3.3 Financial Systems and Policies in Africa and South East Asia: a Comparison

In assessing the financial systems in SSA 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 South East Asia.

In summary, the most notable differences in the financial field between Africa and South East Asia relate to macroeconomic stability and thus to the thrust and confidence in formal financial institutions. This has implications for the degree 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.

4.3.4 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 percent 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 business. They traditionally provide finance for governments (often through regulations imposed by the authorities), for state-owned companies, and for established medium-sized 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 percent 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 nonperforming loans in the banks' portfolios. The existence of large, publicly-owned banks with significant amounts of nonperforming loans lies at the centre of the financial problems in Africa and is a key to understanding the present problems.

The main factors behind the banking sector problems in the five countries studied (Ghana, Tanzania, Uganda, Zambia, and Mozambique) 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.

4.3.5 State Ownership and Privatization

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 reform taking place in most African countries are therefore accompanied by privatization programmes.

4.3.6 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. In most countries in SSA, the weaknesses in competence and experience in the banking sector are now being addressed, partly with the assistance of foreign donors.

4.3.7 Legislation and Regulatory Framework

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 SSA. A legislative and regulatory framework is important in order to give investors confidence in the formal banking system, thereby promoting the domestic resource mobilization.

5. Global Financial Stability and the Development of National Financial Systems³

5.1 Global Financial Stability

5.1.1 *Risks for Global Financial Crises*

The growth of capital flows and the integration of financial markets in the last decades of the twentieth century have increased the probability of global financial crises. Financial markets are inherently volatile, and the asset prices function as a measure of risk. Market agents have developed financial instruments to capture benefits, or to shield against volatility. When financial markets experiment instability, it leads to higher interest rates and risk premiums, and movements of capital flows or exchange rates. All of this constitutes the outcome of agents' uncertainty about the expected returns of investing in financial markets. At "normal" levels of volatility, the price system reflects this uncertainty. Nonetheless, when markets are not able to measure risk, and volatility is perceived as high, financial instability ensues. This may lead to a financial crisis that may spread to other countries and regions.

The last decade of the twentieth century witnessed several financial crises that have generated large economic and political costs, signifying a major step backwards for the prospects of a country's development. These externalities have demonstrated the weaknesses of financial markets as a product of market failures, both at the national and international level. It has also revealed the necessity for making greater efforts to avoid them.

5.1.2 *Financial stability as a global public good*

The occurrence of a crisis cannot be clearly foreseen as economists have not yet fully understood how multiple agents shape their expectations about the market. Nor have they determined the exact causes that lead to financial crisis to countries in terms of their development and welfare, which are much greater and more recurrent in developing countries. The global concern about the costs of financial instability and the international efforts to make the financial system less prone to distress has made "financial stability" continuously treated as a *global public good*. Financial stability as a global public good is the result of national and international policies, and hence a desirable policy outcome.

³ The text below is based mainly on the following titles listed in the Bibliography (Appendix 2): Eichengreen & Bordo, 2001; Huang & Wajid, 2002; Häusler, 2002; IBRD, 2002; IMF, 1998; IMF, 2000; IMF and the World Bank, 2001; Ministry of Foreign Affairs, Sweden, 2001; World Bank, 2000.

The global public good in this case would be the *avoidance of financial crisis*, as it has significant non-excludability and non-rivalrous characteristics and considerable cross-border spill-overs. It is interesting to make a parallel between monetary stability and financial stability.

- *Monetary stability* refers to the stability of the general price level (monetary instability results in inflation).
- *Financial stability*, on the other hand, refers to the absence of stresses that have the potential to cause measurable economic harm beyond a strictly limited group of customers and counter parties.

While monetary stability can be seen essentially as a national matter (that calls for a national central bank authority), it is clear that financial instability and its potential to spread across countries is better viewed both as a national and international matter, where international collective action is desirable.

Three stages of financial crisis – identifying negative externalities and the possible interventions – can be seen:

- The *pre-crisis* period, when the prevention and prediction mechanisms have a bearing;
- The *crisis* period itself, when the mechanisms for crisis management to avoid cross-border spill-overs come into play, and
- The *post-crisis* period, when the main task is to minimize the effects of the crisis, such as the loss in production caused by recession, the cost of restructuring the banking systems, and welfare losses.

Of these three stages, only actions taken during the pre-crisis have the characteristics of non-excludability and non-rivalry. For example, measures such as

- the agreement on financial codes and standards;
- the sharing of information on financial flows and on the situation of financial institutions (which include the flow of information for early warning), and
- the mechanisms for the use of the facility funds to assist countries in financial distress, have global public attributes.

This is not the case for the other two stages. During crisis management, the main mechanism is the use of financial rescue packages, which are region or country specific and are, to a larger extent, excludable and rivalrous. Similar is the case of the post-crisis period, consisting mostly of development interventions and involve the use of resources also excludable and rivalrous (like financial aid, rescue of a banking system). *Hence, when we speak of financial stability as a global public good, our focus is on the avoidance of financial crisis.*

5.1.3 Financial Stability Regimes

Three different types of regimes

Financial stability regimes comprise the conventions, treaties and protocols that formalize agreements for the provision of a global public

good, and reflect the power relations among the actors. In the case of financial stability, these have a strong developed country's bias, as their institutions are mainly conformed by the G-7 or G-10 states (or they maintain large voting power in the decision of the institutions).

There is no unique regime for this global public good. It is possible to distinguish *three different types of regimes*:

- intergovernmental regimes;
- those regimes related to monetary authorities and supervisory institutions, and
- private regimes.

Intergovernmental regimes

The main intergovernmental regimes are those related to the Bretton Woods multilateral institutions, namely the IMF and the MDBs, which are mandated to offer technical knowledge and financial support in the form of capital flows, or injection of liquidity from their own resources or from indirect sources as official bilateral aid or private funds tied to adherence to IMF programmes. Concretely in the case of the IMF, a special regime allows it to attend financial disruptions using its Facility Fund (e.g., Contingency Credit Lines), but also to create international liquidity through the emission of Special Drawing Rights. Another regime is the one furthered by the Paris Club, an informal group of official creditors that provide technical knowledge about the management of debt to find co-ordinated and sustainable solutions to the payment difficulties experienced by debtor nations preventing them from debt default and financial distress.

Central banks and other regulators

The second type of regime is constituted by the agreements of central banks and regulatory institutions about the provision of global standards to the functioning of financial markets. The main institutions related to these regimes are

- the Financial Stability Forum (FSF);
- the Bank of International Settlements (BIS);
- the Basle Committee of Banking Supervision (BCBS), and
- the International Organization of Securities Commissions (IOSCO).

Private actors

The third type of regime is related to private actors, like the London Club, similar to the Paris Club, except its members are commercial banks. The international Accounting Standards Committee (IASC) is also considered in this group. Both types of regimes are mainly related to the agreements on standards and codes and research on financial markets, as well as the provision of technical advice for their members and dissemination of information to the markets. One of the most important proposed regimes is the New Basle Accord for Bank Capital Adequacy, which would be implemented by 2004, and which reflects only the vision of developed countries about the financial market.

5.2 Institutions and Operational Procedures

5.2.1 Standards

Many of these institutions are working together to develop standardization and information transparency mechanisms to avoid and minimize the externalities caused by the information market failures. Such standards, it is hoped, will ease the trade-off between sovereignty and global regulation.

The main question is if markets are able to encourage the implementation of standards. Markets are likely to provide the strongest incentives for economies to implement standards. If private market participants attach increasing importance to information about how far a country meets "best practice" and takes account of this information in their lending and investment decisions, the incentive to implement standards is powerful. The Financial Stability Forum, in collaboration with the international financial institutions (IFIs), such as IMF and the World Bank, standard-setting bodies and other organizations, are working to raise market awareness of international standards.

5.2.2 National and Local Entities involved in the Provision of a Global Public Good

Efforts spearheaded by the *IMF* – and involving *the World Bank, the Financial Stability Forum*, among others – are designed to encourage industrial and developing countries to upgrade their financial practices and institutions. The focus of these efforts is to upgrade institutional arrangements in such areas as

- data dissemination;
- fiscal, monetary, and financial policy transparency;
- regulation and supervision of banking;
- regulation of securities and insurance markets;
- auditing, accounting, bankruptcy, and corporate governance practices.

The institutions responsible for these complementary activities are the Central Banks and the Supervisory Bodies (whose topics are stock market, insurance markets, among others). These institutions not only provide adequate information about the real situation of markets. They also implement mechanisms to isolate actors whose financial problems could generate potential financial crises (bankruptcy laws, prudential regulation, etc).

In general, the public sector is responsible for implementing adequate and healthy macroeconomic policies, in order to maintain the equilibrium of the country. In the *domain of the local*, the central actors are the banking system and the stock markets, which are also responsible for maintaining adequate levels of risk and providing timely, adequate information to markets. Also at the local level, the rating risk agencies provide early warning of potential distress in the financial system via the analysis of information provided by market agents.

5.2.3 Internalizing externalities

Financial markets are intrinsically volatile, and their negative externalities can impose large losses to the agents in the market. However, the

deepening of financial markets (especially in developed countries) has led to the creation of innumerable financial instruments that allow agents to better tolerate their exposure to risks. For example, insurance mechanisms constitute a market mechanism that protects agents from the incidence of financial distress at certain levels. Furthermore, the currency risk that exposes agents to the volatility of exchange rates may be reduced using financial instruments like options or futures. In the same way, other financial instruments and practices like derivatives, hedging, portfolio diversification, among others, can function as mechanisms to internalize the potential externalities of financial distress.

The development of financial instruments, related to the deepening of financial markets, means that it is possible to internalize a large amount of the externalities of the public bad (financial instability), although they are not sufficient to limit the risk of financial crisis.

- Some countries, e.g., Chile, Colombia, and Brazil, have decided to protect their financial systems from the negative effects of short-term capital inflows. The experience of crises has demonstrated that badly managed banks and open international capital markets are a combustible mix for financial crises;
- Another approach is the use of a Tobin tax, a currency transaction tax. The underlying logic is that the tax would slow down speculative, short-term capital flows, as it would tax these flows each time they cross the border, having only marginal effects on long-term flows.

5.2.4 *Public sources of financing*

The international level

When externalities cannot be fully internalized, *public intervention and international collective action* must step in.

- The establishment of *facility funds* to prevent financial crises. The IMF has a special mandate to avoid the spread of financial crisis through the use of its resources to provide financial assistance (including Special Drawing Rights, additional financing, selling of gold reserves, and from trust funds like the Poverty Reduction and Growth Facility (PRGF) and the Initiative for Heavily Indebted Poor Countries (HIPC));
- Resources for the provision of *technical assistance*. IMF's Financial Sector Assessment Program (FSAP) aims to promote the soundness of financial systems in member countries;
- Resources assigned to the *development of standards and codes*. Although many international institutions have the task to develop Standards and Codes to improve the transparency and the standardization of information flows, The Financial Stability Forum is an *ad hoc* international institution dedicated for this purpose;
- The *provision of information* to market agents (data dissemination). The data dissemination activity is financed by the resources of several international organizations, including the IMF and the World Bank.

The national level

The financing mechanisms at the *national level* come from

- the national budget and
- the resources collected from the costs imposed to the supervised institutions (banking, stock markets, insurance markets), and are related to the implementation of the international regimes in a country.

Other financial mechanisms for the provision of the global public good constitute *the national funds to protect saving*. This is also a mechanism of insurance in the case of large bank runs, or the bankruptcy of a financial institution. Similarly, it is possible to consider the country's *monetary reserves* for the same reasons. In this case, the resources from central banks to provide liquidity in the case of financial distress, currency or banking volatility, could be considered as an additional protection fund at the national level.

5.3 Towards a new Financial Architecture to improve Financial Stability

5.3.1 A Specific Developing Country Perspective

The current proposal for the design of mechanisms required to achieve financial stability (mainly designed for developed countries) has led to a debate for the proposal of a new, global and regional financial architecture that incorporates the vision of developing countries. From a developing country perspective, a desirable financial system should accomplish the following key functions:

- (1) appropriate *transparency and regulation* of international financial loan and capital markets, with the progressive assumption of international Codes and Standards, that could present an adequate measure of country risk;
- (2) adequate and opportune provision of international official *liquidity* in distress or crises conditions;
- (3) accepted mechanisms for standstill and *orderly debt work-outs*, that allocate fairly the losses between the different agents after a financial crisis, and
- (4) increased *participation* of developing countries in initiatives for the reform of the financial architecture in order to balance the power relations in the established regimes.

5.3.2 Developing Countries' Concerns

The main concerns about the implementation of a "one fits all" regulatory and supervision framework in developing countries are related to the weak development of their financial markets. One of the central problems of the proposals for the new financial architecture is the lack of participation of developing countries in its design. There are *three areas* where increasing developing country participation in global financial architecture should be considered:

- (1) incorporating developing country participation in *the Financial Stability Forum*, where at present they do not participate even though they are invited to the working groups;
- (2) increasing participation of developing countries in the *BIS* (where there has been some, but clearly insufficient increase in participation) and in *the Basle Committees* (where there is no formal participation, though there has been increased consultations);
- (3) enhancing participation of developing and transition countries in *the IMF Board*. This greater developing country participation would not only be clearly beneficial for developing countries themselves, whose voice would be stronger; it would also benefit
 - the international institutions both by enhancing their legitimacy and by obtaining valuable insights from developing countries, and
 - developed countries as they would ensure greater commitment from developing countries to free and open markets.

6. IMF and World Bank Financial Initiatives⁴

6.1 Weaknesses in National Financial Systems

6.1.1 Recent Experience

To reduce their vulnerability to national and international financial crises, countries must address the weaknesses in their financial systems. Since the mid-1990s, financial crises have erupted in half a dozen developing and emerging countries in Asia and Latin America as well as in Russia. The costs for the countries affected have been heavy, with the crises leading to

- bank failures;
- corporate bankruptcies;
- job losses;
- increased fiscal burdens;
- depletion of foreign exchange reserves;
- depressed economic activity, and
- even, in a few cases, political and social turbulence.

Initial research on the causes of the crises have highlighted

- weaknesses in the afflicted countries' economic fundamentals;
- excessive short-term foreign borrowing by governments and private sector entities, and
- volatile short-term capital flows.

Recent studies, however, increasingly point to the important role of *weaknesses in national financial systems* in triggering or exacerbating crises. For this reason, the international community has been stepping up its assistance in strengthening banks and other financial institutions. After all, the whole – the international financial system – cannot be healthy if its parts are not.

6.1.2 Why are Countries vulnerable?

Globalization

With the globalization of finance, firms and sovereign borrowers in

⁴ The text below is based mainly on the following titles listed in the Bibliography (Appendix2): Häusler, 2002; IMF, 2000; IMF and the World Bank, 2001; Klasen, 2003; Ravallion, 2002; UN, 2000; World Bank, 2000.

countries around the world have increasingly obtained financing in the international financial markets. Between 1970 and 2000, cross-border capital flows increased from less than 3 percent of GDP to 17 percent for advanced economies and from virtually nothing to about 5 percent of GDP for developing countries.

The fundamental benefits of financial globalization are well known – by channelling funds to their most productive uses, it can help developed and developing countries alike achieve higher standards of living. But sudden reversals of capital flows – which may occur because investors have doubts about the viability of domestic policies of financial institutions;

- are retrenching in response to crises in another part of the world;
- or are shunning countries with similarities to a country in crisis – can threaten national and international financial stability.

Banks with substantial net foreign exchange liabilities or outstanding foreign-currency loans to domestic companies with revenues in local currency may be hit especially hard if the currency depreciates, as the Thai baht did in 1997, or if interbank credit lines are withdrawn.

Recent Research

Recent research suggests that the chances of a country experiencing a financial crisis may have increased with *globalization*, possibly because technological advances enable funds to move into and out of countries more rapidly. A study (carried out by Barry Eichengreen and Michael Bordo in 2001) reveals that the probability of a randomly selected country experiencing a crisis has doubled since 1973.

In addition, *currency crises* became much more frequent in the final quarter of the twentieth century, both alone and in conjunction with banking crises.

Also, *financial instability in a single country* can threaten the stability of the entire international financial system, as was the case in 1998 when Russia defaulted on its debt and devalued the ruble. Investors around the world incurred large losses and stock markets tumbled in both emerging markets and industrial countries.

IMF support

To achieve financial stability, countries need financial systems that are deep, broad, and resilient; they must address the weaknesses that make their systems vulnerable to shocks. To help countries strengthen their financial sectors and to preserve the stability of the international financial system, the IMF – as part of an international effort – has intensified its work on financial sector issues.

6.2 The role of the IMF and the World Bank

6.2.1 General Approach

The IMF has adopted a *three-pronged approach*:

- (1) helping member countries carry out comprehensive *assessments* of financial sector vulnerabilities and development needs;
- (2) strengthening the *monitoring and analysis* of financial sectors, developing

guidelines, and promoting transparency and integrity, and
(3) helping countries *build strong institutions*.

Assessment of financial sector vulnerabilities

The centerpiece of the IMF's efforts is the *Financial Sector Assessment Program (FSAP)*, launched jointly with the World Bank in 1999. The FSAP – essentially a health checkup of a country's financial system – is designed to help policymakers identify strengths and vulnerabilities and devise measures to reduce the potential for crises.

6.2.2 FSAPs

Contents in general

FSAPs typically include *appraisals* of the relative importance of the various financial institutions in the system:

- the *sensitivity* of the financial system to shocks under alternative scenarios, and
- *financial soundness* indicators, such as
 - capital-adequacy ratios;
 - extent of nonperforming loans in banks' portfolios, and
 - earning trends.
- They also include *institutional assessments* of
 - liquidity developments and policies;
 - the crisis-management framework;
 - the regulation and supervision of the financial sector codes and standards, and
 - the requirements for further financial sector development.

The *analytical work* focuses on developments both

- in the aggregated measures that are useful indicators of the soundness of *financial institutions*, and
- in other indicators of the financial health of the main *nonfinancial counterparties* (households and corporations) of financial institutions, as well as
- on the behaviour of the *macroeconomic variables* that are closely associated with the performance of the financial system, such as interest and exchange rates.

In addition, the *impact* of macroeconomic and other *shocks* on the profitability and solvency of financial institutions is subjected to *sensitivity and scenario analysis* – stress testing, which is undertaken in cooperation with officials in the country and often proves helpful in building risk-management capacity. The *implications of weaknesses* in the financial sector *for macroeconomic stability* are also considered.

Codes and Standards

Assessments of the extent to which financial sector codes and standards are observed make it possible to

- identify gaps in regulation and transparency;
- evaluate the overall stability of the financial system; and

- measure a country's practices against international benchmarks. Among the *standards* covered are
- the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies;
- the Basle Core Principles for Effective Banking Supervision;
- the Core Principles for Systemically Important Payments Systems;
- the International Organization of Securities Commission's Objectives and Principles of Securities Regulation; and
- the International Association of Insurance Supervisors' Insurance Supervisory Principles.
- (When relevant, observance of standards and best practices in other areas – for example, corporate governance and insolvency and bankruptcy regimes – is also assessed.)

More recently, as part of the international community's effort to promote the integrity of financial systems and prevent their abuse, FSAPs have also begun to systematically cover provisions for combating *money laundering* and the legal and institutional aspects of *financing terrorism*.

Co-operation between IMF, World Bank and National Authorities

A collaborative effort involving experts from the IMF, the World Bank, and various national agencies and standard-setting bodies, and FSAP involves the assessment of a wide range of financial institutions (such as banks, mutual funds, and insurance companies);

- the financial markets themselves (securities, foreign exchange, and money markets);
- payment systems; and
- regulatory, supervisory, and legal frameworks.

While *the IMF* tends to focus on issues concerning systemic *financial sector risks* and vulnerabilities, particularly as they relate to macroeconomic stability, *the World Bank* focuses on issues related to *development and poverty reduction*.

The team carrying out an FSAP discusses its findings with the national authorities during the *IMF's Article IV consultations* (regular – typically annual – reviews of a country's economy). The IMF then prepares a *Financial System Stability Assessment (FSSA)* for its Executive Board. The FSSA, which draws on the FSAP findings as well as discussions during Article IV consultations, is focused on issues of macroeconomic stability related to developments in the financial sector. The FSSA also includes a *Report on the Observance of Standards and Codes (ROSC)*.

Scope of implemented FSAPs

By the end of 2001, more than one-third of the IMF's 183 members had participated in the FSAP or volunteered to do so in the future. Financial sector assessments had been completed for 25 countries, 20 were under way, and 23 countries in the East Caribbean Central Bank area had formally committed to one in the future. These countries represent a broad cross-section of the IMF's membership, geographically and in terms of stage of development.

During the last review of the FSAP in November 2000, the IMF's Executive Board agreed that, in any one year, somewhat greater priority should be given to systematically important countries – that is, countries whose economic troubles could have repercussions in other countries. In that regard, the finance ministers and central bank governors of the G-20 countries (many of which are considered systemically important) agreed at their inaugural meeting in June 1999 that they should participate in the programme. More than half of them have already done so or are formally committed to doing so.

Indeed, the FSAPs already completed span a broad spectrum of countries with different institutional and market structures, including Canada, the Czech Republic, Hungary, Ireland, Japan, Korea, Kazakhstan, Poland, Slovenia, South Africa, Sweden, Uganda, the United Kingdom, and Yemen.

Monitoring, analysis, transparency, and integrity

Health checkups and risk profiles are only as good as the intelligence available, so the IMF is pushing for better, more extensive, and timelier information to enable it to carry out deeper, more thorough, and more accurate analyses. In this context, it is strengthening its own information base for frequent monitoring of financial sector developments and refining its stress-testing methodologies and its analysis of the links between the financial sector and macroeconomic performance. It is also encouraging countries to improve the transparency and integrity of their financial systems. Efforts in these areas are concentrated on the following *main activities*:

- *Developing and fostering standards.* The IMF's Code of Good Practices on Transparency in Monetary and Financial Policies seeks to make more information available to market participants so that they can make better informed decisions. The IMF is also working with other standard-setting bodies.
- *Developing early warning systems.* From its Washington headquarters, the IMF is monitoring the financial sectors of individual countries – particularly when there is a risk of systemic instability stemming from the financial sector – so that potential problems can be identified early on and steps taken to avert or mitigate a crisis.
- *Developing financial soundness indicators and methods of macroprudential analysis.* The financial soundness indicators include a core set of aggregated prudential indicators of the banking sector and a broader set of indicators that cover the financial health of the nonbank financial, corporate, and household sectors and real estate markets. The IMF is also developing readily applicable stress-testing methodologies for off-site analysis of vulnerabilities.
- *Developing guidelines, in collaboration with the World Bank, for the management of debt and foreign exchange reserves.* The guidelines are based on best practices worldwide. The two institutions are also helping countries build the necessary institutional infrastructure.
- *Developing guidelines for sequenced and coordinated capital account liberalization.* Many of the countries in which crises erupted had rapidly eliminated controls on capital inflows. However, capital account liberalization

needs to be carried out carefully, in conjunction with the development and strengthening of the domestic financial system. The IMF is therefore working to formulate some general principles for the orderly liberalization of capital flows.

- *Promoting the integrity of financial systems.* The IMF has developed a methodology enabling national and international authorities to assess the adequacy of a country's apparatus for preventing money laundering and is also collaborating with the Financial Action Task Force to expand the methodology to encompass the arrangements for combating financing of terrorism.

Institution building

Many countries lack the institutional capacity to supervise and regulate their financial sectors or to gather the data they need to obtain an accurate picture of the health of their financial institutions. The IMF is working with the World Bank and other donors in co-ordinating *technical assistance* for institution building.

The IMF also provides technical assistance aimed at eliminating deficiencies identified during assessments of *offshore financial centers (OFCs)* – that is, the operations conducted abroad by a country's domestically registered financial institutions.

6.2.3 Some Conclusions

IMF/World Bank programmes

Participating countries acknowledge the value of an objective and comprehensive assessment as well as of the peer review aspect of the program. However, they also say that there is *scope* for *further refinements* and *extended coverage* in such areas as

- stress testing;
- informal markets;
- legal frameworks and enforcement capacity, and
- consistency in the analysis of issues across countries.

The IMF's efforts to strengthen the information, analysis, and monitoring of financial sector risks and institution building will, by their very nature, take longer to bear fruit.

While it is impossible – and even undesirable – to have a foolproof system that eliminates all risk taking, a sound financial system would strengthen the capacity of countries to cope with difficulties when they arise. *The success of the IMF's efforts will be judged by*

- the extent to which such capacity is enhanced, and
- the frequency and severity of future systemic financial crises.

Beyond this, it will be reflected in *the financial system's*

- enhanced depth and breadth, and
- its contribution to economic growth.

Pro-poor growth – a new, added dimension

The general ambitions and structure of the IMF/World Bank programmes introduced during the last decades have been met by strong

criticism from different quarters. To give a perspective on this, it is worth while to make some comments on pro-poor growth, which is a fairly recently introduced new way of thinking. It has a focus that in essential respects differs from the traditional IMF/World Bank approach presented above.

A recent paper (Klasen, 2003) discusses the pro-poor growth concept at length. It states that lately in policy and research documents from various institutions, researchers and organizations (e.g., UN, 2002, World Development Report, the World Bank, 1997, 2000, 2002, the World Bank, 2000, Ravallion, 2002) identify pro-poor growth as the most important ingredient to achieve sustainable poverty reduction.

As poverty reduction has become the central aim of development efforts, as evidenced by the Millennium Declaration, the PRSP process, and the associated lending instruments by the IMF and the World Bank, aiming for pro-poor growth, is a fortiori, the most significant policy measure to achieve this goal.

Despite being widely used, the term is not well-defined nor has there been a clear policy document that would summarize the determinants and policy implications of pro-poor growth. The Klasen paper seeks to fill this void by first proposing a definition of pro-poor growth, then summarizing the linkages between inequality, poverty, and pro-poor growth, before proceeding to analyse the micro and sectoral determinants of pro-poor growth. The final section of this paper spells out the recently emerging consensus on policy implications for pro-poor growth, with particular emphasis on policy issues in sub-Saharan Africa and points to remaining disagreements and areas for further research.

The Klasen paper gives specific comments on, among other things, the use of monetary and exchange rate policy. It shows e.g., that while the World Bank tends to suggest a 'competitive' exchange rate, some argue that governments should manage capital flows to generate an undervalued exchange rate to provide incentives to export and to build up cushions against inevitable external shocks.

Liberalized capital accounts and domestic financial markets used to be a key ingredient of Structural Adjustment Programmes, but here opinion appears to have shifted considerably. Liberalized capital accounts have often led to capital flight or high volatility in capital flows, particularly in countries where other macroeconomic imbalances persisted. Liberalized financial markets have not delivered higher savings or financial deepening as promised but have often led to high spreads and high real interest rates.

The new consensus that appears to be emerging is that the capital account should be liberalized only gradually and only in an environment of overall macro stability. Financial liberalization should also come after some other reforms (notably reduced budget deficits to lower the public's demand on funds in the domestic capital markets) and include pro-active measures to improve access of the poor to financial services (through commercial and non-commercial micro credit institutions), measures to foster competition and better regulation.

Lastly, there also appears to be a clear consensus emerging on the role of aid in these reforms to deliver pro-poor growth. One important lesson of the Structural Adjustment era was that it was problematic and unsuc-

cessful to drive policy reform from outside, using aid conditionality. It was precisely this realization, combined with the emergence of the debt crisis and increasing pressure from NGOs in North and South that led to the new approach to aid that is embodied in the combination of HIPC and the PRSP process.

The disappointing experience with adjustment as well as a constructive debate among proponents and critics of adjustment have generated a new middle ground of policies that could foster pro-poor growth. However, there are still large differences of opinion and more work is clearly needed as the current wish-list for pro-poor growth is very long and some kind of sequencing, prioritizing, and packaging is critical.

It has to be stressed, that there continues to be considerable differences between policy papers and actual operational work.

7. Sida-related Projects⁵

7.1 The UN Conference on Financing for Development in Monterrey, Mexico, March 2002

Sida's participation

In connection with the 2002 UN Conference on Financing and Development in Mexico, Sida organized a seminar on "Local and international capital markets for infrastructure financing – new techniques and the role of ODA". The theme was motivated by the direction of the conference, with "Mobilizing domestic financial resources for development" as the first point on its agenda. Furthermore, Sida is one of a very few donor organizations having both developed a guarantee programme and having also implemented some guarantee projects. For this reason, Sida is able to present experience from guarantee activities. Over the years, a number of programmes with similar aims have been developed elsewhere but very few have resulted in any substantial activity. Exceptions are the guarantee activities of the IFC, the World Bank and MIGA.

The main aim of the seminar was to present *Sida's "GuarantCo" project*, invite points of view and have a discussion about the project. This way Sida would be given an input as to the further development of GuarantCo. Another aim was to discuss possibilities and challenges related to the use of local capital markets for financing infrastructure projects.

GuarantCo – the rationale

GuarantCo is the working name of a project initiated by Sida and which is initially implemented together with UK's *Department for International Development (DFID)*. At a later stage also other donors will be invited to participate. *The rationale for GuarantCo* is according to *Sida's concept paper* as follows: In spite of the widespread weaknesses of capital markets in SSA, successful 4-year notes issued by Uganda's telecommunication firm MTN demonstrate that long-term financing for infrastructure projects can be mobilized from local capital markets in the region. A guarantee provided by Sida was instrumental in making MTN's notes attractive to investors and acceptable to the regulatory authorities.

⁵ The text below is based mainly on the following titles listed in the Bibliography (Appendix 2): Engström, 2002; Garman & Jansson, 2002; IMF, 2003; INEC/Sida, 1997; Isacsson & Levin, 1999; Ljung & Serge, 2002; Mistry & Olesen, 2002; SOU 2001; Woodbridge, 2003.

A Multi-donor facility

Inspired by this positive experience, GuarantCo is envisaged as a multi-donor facility under the tutelage of the *Private Infrastructure Development Group (PIDG)*. First conceived as a sister organization to *Emerging Africa Infrastructure Fund (EAIF)*, GuarantCo would *build on* the donor co-operation within the PIDG group and *complement* EAIF and its Fund Manager.

It would aim at achieving a major advance in solving the problem of mobilizing local currency debt with long tenors in SSA countries. GuarantCo is seen as a way of pooling donor resources. Thus, it would lower transaction costs and reach a broader set of countries and project developers with greater impact than if various donors proceeded separately.

Objectives of GuarantCo

GuarantCo would provide credit enhancements to local issuers of bonds and other debt instrument with the overriding goal of accelerating economic growth and alleviating poverty by mobilizing domestic financing for private infrastructure projects.

GuarantCo would,

- through its bond guarantees, compensate for local investors limited capacity to assess default risks.
- by providing the markets with attractive, tradable products, help to develop local capital markets.
- as a donor sponsored entity, also provide impartial advice or demonstrate "Best Practice" to policy makers and regulators.

7.2 Co-operation with the Swedish Riksbank

During the last four years, Sida together with the Swedish central bank implements a project aiming at creating co-operation arrangements between Sveriges Riksbank and the central banks in Uganda, Vietnam and Sri Lanka.

The co-operation should not be looked upon as a consultancy effort based on a ToR. It builds instead on a dialogue between individual officials in the central banks involved. The Riksbank never gives advice on how to do. Instead it presents details of its own operations, assessing with hindsight good and bad experience.

The co-operation between the Riksbank and the Central Bank of Sri Lanka was the first project and it is still going on. It has resulted in a number of visits in Sweden and Sri Lanka by officials involved.

Details on the Swedish-Sri Lanka co-operation

The co-operation between the Swedish Riksbank and the Central bank of Sri Lanka (CBSL) started three years ago and deals with monetary policy and financial stability. During the last 20 years the Riksbank has gathered experience from a process where Sweden has moved from regulations of interest rates, credits and foreign exchange to an unregulated financial market. Now Sri Lanka is part of a similar large and revolutionary process of change.

Sri Lanka now has changed its monetary and foreign exchange policies and the central bank has become more modern and more specialized. In its Annual Report 2002, the CBSL presents its Monetary Policy Framework (updated 04 June 2003). To illustrate the state of arts of the CBSL, the Bank's presentation of its ***Monetary Policy Instruments*** is quoted below.

The *Monetary Law Act* provides the Central Bank with an array of instruments that could be used for implementing monetary policy. The main instruments available are:

1. Operations in foreign exchange, i.e., external reserve management, changes in the exchange rate and exchange control regulations.
2. Credit operations with banking institutions:
 - (a) Credit to commercial banks by the CBSL – this includes refinance facilities and other credit to commercial banks and other financial institutions
 - (b) Emergency loans to commercial banks in distress (lender of last resort facility).
3. Reserve requirements on commercial bank deposits:

To limit the creation of money and credit, the CBSL requires the commercial banks to maintain a portion of their deposit liabilities as reserves (the statutory reserve requirement – SRR).
4. Quantitative restrictions on credit:
 - (a) Impose maximum maturity for commercial bank loans and advances.
 - (b) Limit or prohibit rate of expansion of new loans and advances.
 - (c) Fix minimum values for the ratios of capital and surpluses to assets.
 - (d) Impose minimum deposit margins for letters of credit.
5. Interest rates:
 - (a) Determine interest rates at which CBSL provides various types of credit to banks and other financial institutions.
 - (b) Fix the maximum interest rates that banks can pay on their deposits or charge for their loans.
6. Open market operations:
 - (a) Purchase and sell government or government guaranteed securities in the open market to control market liquidity.
 - (b) Issue its own securities to absorb liquidity.
7. Moral Suasion (Although not explicitly indicated as a tool of monetary policy, and having no legal backing, this is a means whereby the Central Bank uses its influence with commercial banks to persuade them to adopt desired courses of action).

Thus, the Central Bank can influence money supply, availability of credit and interest rates using these policy instruments, either individually or as a combination.

Selected Macroeconomic Indicators – cfr Appendix 1. Score Card

CBSL's Annual Report 2002 presents in its *Chapter 1 – Economic Performance, Outlook, Issues and Policies* – text comments as well as tables and charts covering macroeconomic indicators. An excerpt from Table 1.1 *Selected Macroeconomic Indicators* from Chapter 1 is presented below in order to give an illustration of possible information to be included in a Score Card for Sri Lanka. The use of a Score Card as an instrument for *Monitoring the Financial Performance of Co-operating Countries* is dealt with in Appendix 1.

Selected Macroeconomic Indicators (Sri Lanka)

	1980–89	1990–97	1998	1999	2000	2001	2002
	avg	avg					
GDP (real) growth rate							
GDP deflator							
GDP (nominal), per capita, rupees							
GDP (nominal), per capita, US dollars							
Unemployment rate, per cent							
Import coverage of foreign assets, months							
Gross foreign assets							
Gross official reserves							
	<i>Per cent of GDP</i>						
Gross domestic investment							
Gross domestic savings							
Foreign savings							
Balance of payments, current account							
Budget, current account balance							
Budget, overall balance							
Money supply (M2b), per cent change							
Colombo Consumers' Price Index, per cent change							
Exchange rate (Rs/US\$), per cent change							

7.3 Sida Participation at the Emerging Africa Infrastructure Fund

Purpose

The U.K Government's *Department for International Development (DFID)* has initiated a debt fund for the sub-Saharan Africa (SSA) region on a donor/private sector-partnering basis. The *Emerging Africa Infrastructure Fund (EAIF)* is mandated to extend long-term lending to private sector infrastructure projects in SSA countries. The aim of EAIF is to increase the volume of private capital flows into infrastructure projects in the SSA region. Key is an active partnership with the banking community. EAIF will focus exclusively on SSA and on debt.

Its *unique feature* will be a financial structure in which grant subscribers create an "equity cushion" for non-concessional lenders. EAIF's capital and lending structure will allow participating financiers to diversify and mitigate their risks. It is believed that EAIF will make a material contribu-

tion towards facilitating critical infrastructure service provision in SSA countries, holding out the promise of consequent acceleration of economic growth and poverty alleviation.

Funding

EAIF will initially be funded by US\$100 million of equity contributed by DFID; the donor equity is expected to grow to US\$150 million through contributions from Sida, SECO of Switzerland and the Netherlands. The donor contributions will be channelled to EAIF via a special-purpose Trust. The Trust will invest the donor funds in EAIF as shareholders' equity to help attract commercial lending to infrastructure. As such the donor-funded Trust would be the sole owner of the EAIF funds. Sida's intention is to make US\$20 million available to the EAIF through a Conditional Loan to the Trust.

Leverage

EAIF will leverage the donor funds/equity by acquiring long-term debt on commercial terms in an initial amount of US\$205 million, which is expected to grow to at least US\$300 million. The debt will be sourced from private sector banks and official development finance institutions. The total funding of EAIF is accordingly US\$305 million with a potential to reach over US\$450 million. Depending on the average participation share of the Fund in the financing of individual projects – estimated to be in the 25–30% range – the Fund could facilitate project financing in the range of US\$1 – 1.6 billion.

7.4 FIRST – The Financial Sector Reform and Strengthening Initiative

Introduction

During the Summer of 2001, Sida was approached by the UK DFID (Department for International Development) with a request for participation in a multidonor facility, *Technical Assistance for Standards and Codes Facility (TASC)*. The idea to establish this facility originated in the aftermath of the large South East Asia financial crisis 1997–98. In September 2001, Sida informed DFID that it saw large benefits to be derived from participating in TASC – with its poverty alleviation ambition – and that Sida intended to grant a financial assistance of MSEK5 annually during a three year period.

During the first quarter of 2002, DFID held discussions with the IMF and the World Bank about merging the TASC Initiative with a similar IMF proposal regarding financial sector technical assistance to developing countries. As a result of these discussions, a decision was made to establish a mutual project, titled *FIRST, the Financial Sector Reform and Strengthening Initiative*. In May 2002, Sida received a proposal for support to FIRST. Based on an internal proposal, Sida will participate in FIRST (Low Income Trust Fund) with MSEK20 in total during the coming four years.

Background, focus and motives

The FIRST Initiative may be seen as a complement to the IMF/World Bank FSAP (Financial Sector Assessment Programme) and the ROSC

(Reports on Observances of Standards and Codes) programmes. In May 1999, IMF and the World Bank started the FSAP, the analyses of which complement the ROSC analyses, used by IMF since the beginning of the 1990s. As elaborated on in Chapter 6 above, the FSAP reports, as well as the traditional ROSC reports, are used by the IMF in its regular work to supervise the international financial system and by the World Bank in its work supporting institutional changes among the developing countries.

Experience from FSAP and ROSC analyses demonstrates that many low and middle income countries lack both personnel and financial possibilities to follow up international experts' recommendations to restructure their financial systems. In order to correct the shortages, it is important to undertake projects for capacity building. This should involve the staff working inside the countries' financial sector supervision and regulating authorities. FIRST is – through implementing preparation activities – thought to function as the link between FSAP/ROSC and technical assistance for financial sector development.

Target groups and hierarchy

FIRST's *target group* will be ministries, authorities and organizations in the cooperating countries, who deal with developing the financial system. This includes primarily ministries of finance, central banks, financial supervising authorities and bank support agencies. Private organizations, such as stock markets and industry organizations inside the financial sector, may also get FIRST assistance. The countries, who may be eligible for FIRST assistance, are low and middle income countries who according to OECD/DAC are classified as either Developing or Transition Countries.

FIRST *aims* at supporting capacity development through a large number of different types of activities (different countries, areas, problems, risk factors, etc) according to the following model:

Development targets: Contribute to develop robust, sustainable and effective financial systems in the cooperating countries.

Project targets: The participating institutions have a capacity to regulate, follow up and supervise the financial markets in their respective countries in a way that is satisfactory to the IMF and the World Bank.

Expected results

- 1) Improved rules and regulations for *regulation and control/supervision* of financial institutions;
- 2) Activity *plans for restructuring* the financial markets produced and approved;
- 3) Improved routine methods for *registration and analysis* of transactions in the financial system;
- 4) More effective and more rapid routines for *disclosing financial information* to the IMF, the World Bank, bilateral donors and relevant interest groups in the market.

Activities

- 1) *Channeling assistance* to the co-operating countries in questions dealing with regulation, follow up and analysis of financial markets;

- 2) *Stimulating information exchange* of methods, capacity development and reform of relevant institutions in the co-operating countries;
- 3) *Mobilizing capital* for technical assistance from bilateral donors and co-ordinated efforts between different donors;
- 4) *Supporting research* about and disseminate know-how of Best Practice in questions regarding supervision of financial systems;
- 5) *Developing contacts* with relevant international standards promoting organizations, academic institutions, private consultants, etc. The aim is to broaden the base for recruiting expertise in order to implement follow up efforts to FSAP and ROSC.

Organization, members, and capital use

FIRST is managed through two foundations, *FIRST Middle Income Trust Fund* and *FIRST Low Income Trust Fund*, each based on an own Programme Charter. The World Bank is founder (trustee) of both trust funds. The donors are represented in a *Governing Council (GC)*, in which each donor has one voice. The GC meets once every year and shall approve the policies of the activities, strategies, annual working plan and annual budget.

According to its web site (www.firstinitiative.org), FIRST is guided by a *Governing Council* composed of representatives from the World Bank, the IMF and most of the bilateral donors that are providing financing. Governing Council members nominate representatives for FIRST's *Steering Committee*, which provides strategic guidance to the operational management and approves larger technical assistance projects.

FIRST is operationally managed by a *Management Unit (MU)* in London, staffed by private sector consultants, and a *Co-ordination Unit (CU)* in Washington, made up of personnel contracted by the World Bank and the IMF. The MU's responsibilities are managing technical assistance projects and procuring consultants, whereas the CU is responsible for the Information Exchange, the management of sensitive and confidential technical assistance projects and partner co-ordination.

The majority of technical assistance funded by FIRST is provided by a Panel of consultants. In addition, from time to time, FIRST draws on registered private sector consultants and staff from official agencies.

Assistance money from FIRST shall be additional. Project proposals for FIRST technical assistance should be submitted directly to its Management Unit by

- eligible recipients, i.e., the countries who according to the statutes are entitled to receive contributions, or
- on their behalf (at the request of each respective country) by the World Bank, the IMF, standard setters, or other multilateral and bilateral agencies.

FIRST's Management Unit is responsible for managing the delivery of projects that are not being led by World Bank or IMF staff. The Co-ordination Unit is responsible both for building an information exchange on financial sector technical assistance and capacity building, and for managing the delivery of projects being led by the World Bank or the IMF. Technical assistance is provided by experts engaged by FIRST.

The number of FIRST members and donors will gradually increase. In September 2002, there were two multilateral donors (IMF and the World Bank) and four bilateral donors (UK, Switzerland, Canada, and the Netherlands). Discussions are under way with Japan, Spain, France, Germany, Australia, New Zealand, and EU concerning FIRST membership.

FIRST, which started its work in April 2002, *is not aimed at being a new permanent institution*. Rather it shall participate in creating sustainable financial systems in the co-operating countries. So far, experience indicates that demand for FIRST money will be largest within the following five areas:

- insurance;
- ownership control;
- pension reforms;
- anti-money laundering, and
- regional programmes.

General information and priorities – on 2003 FIRST Initiative’s web site FIRST supports activities and interventions mainly in the public sector, principally by providing technical assistance grants to policy makers and regulatory bodies. It also supports private sector activities when organized through recognized institutions, for example stock exchanges, self-regulatory organizations, and industry associations. In most cases, FIRST cannot provide support to a specific non-regulatory institution, for example an individual bank, insurance company or a brokerage house.

FIRST’s core activities include the provision of advisors (individuals, consulting firms and from official agencies). FIRST also funds training in or out of country; secondment of experts; peer group workshops; and other forms of peer support including the supply of relevant third country and World Bank and IMF materials. Usually, non-technical assistance activity must be linked to an identifiable reform programme, whether supported by FIRST, another donor, or by the recipient country.

FIRST supports the dissemination of information on best practices and useful tools that relate to financial sector reform and development in low-income and middle-income countries. An *Information Exchange* delivers information on financial sector development assistance in the world, by offering information on current and completed projects. In addition, FIRST will offer a live service, *AskFIRST* to respond to all FIRST related queries and deliver customized information on financial sector reform and development activities.

FIRST’s focus is on supporting short- and medium-term projects. Its technical assistance projects range in size from a few thousand dollars up to US\$500,000 and, exceptionally, more. The majority of projects supported to date have been between US\$100,000 and US\$200,000.

Priority projects for FIRST are those that:

- Help implement the recommendations of FSAPs and ROSCs
- Build a country’s capacity for FSAPs or ROSCs
- Need rapid mobilization of resources, or are below other donors’ minimum thresholds

- Leverage FIRST resources, for example, by acting as a catalyst for wider donor intervention in a particular area, or projects that present strong potential for replication
 - Are regional or multi-country projects.
- Projects supported by FIRST can be found on its web site.

7.5 Financial performance in Uganda and Zambia – Comparison of two Sida Co-operating Countries⁶

7.5.1 Background and Purpose

A comparative investigation into the economic and financial developments of Uganda and Zambia during the last 20–25 years is summarized below. The selection of these two – with Sida co-operating – countries for a comparison, is based on clear-cut performance differences. Recent economic and financial performance between the differ a lot in spite of large similarities in the conditions at the outset of the period studied.

In sum, the main explaining factor behind the performance differences seems to be the handling of economic policies and structural reforms. In this comparison, a special focus is put on the development of the financial sector and the use of monetary policy.

Table 7.1 Uganda and Zambia compared – Some Key Economic and Financial Indicators

	Uganda		Zambia	
1. General Indicators				
Independence	1962, from UK		1962, from UK	
Population	24 mill		10 mill	
Language	English		English	
Reading Capacity	62%		78%	
Political System	Republic, one party		Republic, multi party system	
Judicial System	UK common law		UK common law	
Natural Resources	Minerals, water power,		Minerals, water power	
	arable land			
2. Macroeconomic				
Indicators				
GDP/Capita	\$1 100		\$880	
	Production	Employment	Production	Employment
Farming	43	82	18	85
Industry	17	5	27	6
Services	40	13	55	9
Population below				
the poverty line	55%		86%	
Unemployment	NA		50%	
Inflation	below 10%		20–25%	

⁶ Text and figures below regarding Uganda and Zambia build on reports by the IMF/World Bank, CIA, and the local ministries of finance, central banks and local other authorities. The material is mainly collected from reports available on official Internet web sites.

3. Financial and Monetary Policy Indicators in % of GDP		in % of GDP
Budget Balance	-10%	-12%
Current Account Balance	-14%	-12%
External Debt	14%	81%
Financial Assistance	8%	5%
Exchange Rate, 96	1 046 shilling	1 208 kwacha
01	1 830 shilling	4 025 kwacha
Instruments affecting	TBill Sales, Repos	T Bill Sales, Cash & Liquidity
Bank Liquidity	Reserve Requirements	
Policy rates	Rediscount, bank rates	Penalty rate
Monetary growth	Below 10%	20–30%
Interest Rates	Below 10%	25–50%
4. Financial Market Data		
Banks	17	15
Non-bank Financial Institutions	49	12
Financial Depth = Broad money M2/GDP	20%	20%
Micro Finance Inst	101	NA
Treasury Bill Market	364 Days, max	273 Days, max
Government Bond Market	NA	12, 18 & 24 months, max

7.5.2 The Uganda Case

The General Economy

At the Outset, 20–25 years ago, the situation in Uganda was characterized by

- an economic crisis with negative GDP growth and high inflation;
- an overvalued fixed exchange rate;
- strict government control of nominal interest rates; the real interest rates were negative, i.e., the nominal interest rates were lower than the inflation rate;
- a weak current account balance;
- deteriorated credit mediation on underdeveloped financial markets.

During the 1980s, an IMF-led structural adjustment programme started.

Already a stand-by agreement with IMF was in place. A civil war, however, delayed its practical start until 1987 when a new government was established. Main features of the programme were

- fiscal and monetary discipline;
- elimination of distorted prices;
- stimulation of free trade, payments and foreign exchange.

During the 1990s, the economy improved in many respects:

- Inflation was reduced dramatically, already from the end of the 1980s;
- Real interest rates turned positive;

- 1989/90. A variable exchange rate was introduced through a "crawling peg" regime; the exchange rate was aimed at granting external competitiveness;
 - Sustainable production growth;
 - Falling international interest rates have had a positive effect;
 - 1992–94 was a period of liberalizing interest rates;
 - During 2000 Uganda qualified for "Enhanced HIPC Debt Relief".
- The Financial System and Monetary Policy
- During the 1970s and 1980s*, the Monetary Policy included
- Reserve Requirements;
 - Direct Credit Control;
 - Interest Rates formally decided by the Bank of Uganda/Ministry of Finance;
 - Auction of Treasury Bills.

At present an independent Bank of Uganda manages Monetary Policy through *indirect means*, i.e.,

- 91 Days Treasury Bills interest rates;
 - Reserve Requirements;
 - Two Bank of Uganda lending facilities, a) rediscounting, b) lender-of-last-resort.
- The financial market* is characterized by
- a flexible exchange rate;
 - reform work regarding the financial sector and its supervision and control.

7.5.3 The Zambia Case

The General Economy

At the Outset, 20–25 years ago, up to the beginning of the 1990s, the main economic characteristics were as follows:

- An economy directed and managed by the government;
- Stagnation and high inflation;
- Strict control of the economy;
- Dependence on the copper industry;
- Large deficits in the budget and current accounts;
- Dependence on assistance from abroad.

During the 1990s, main changes happened, especially related to the introduction of IMF's structural adjustment programme in 1991:

- Restructuring a stagnating government-directed economy to a market-oriented economy;
- Liberalizing trade and foreign exchange transactions;
- Liberalizing farming policy;
- An ambitious privatization programme.

The structural adjustment programme results can be characterized as follows:

- Macroeconomic stability – limited progress. Continued high inflation and unemployment;
- Opening up of the economy to market solutions – important progress. Freed pricing;
- Many government-owned corporations restructured and moved to the private sector;
- Limited success in poverty alleviation;
- Weaknesses in economic management, which is crucial for mobilizing financial and technical assistance;
- 2000. Access given to HIPC Debt Relief.
- An updated Debt Sustainability Analysis concludes that Zambia's external debt will not be reduced to sustainable levels in many years – not even if the financial policy is strong, nonconcessional borrowing is avoided, and traditional mechanisms of debt relief are used. As a consequence Zambia applies for Enhanced HIPC Relief.

The Financial System and Monetary Policy

Zambia has been late to develop its financial system and monetary policy. The financial system, including the Bank of Zambia, has been state-dominated and in its credit mediation prioritized the government and government-owned companies. Not until recent years – and as a part of IMF-led programmes – a development has started. The *aim of Zambian Monetary Policy ahead* is

- to limit/control inflation;
 - stabilize the foreign exchange market;
 - let interest rates and exchange rates be more flexible in order to reflect market forces;
 - intervene only with the aim of maintaining international reserves according to its programme.
- Further, the *ambitions* include
- giving Bank of Zambia more capacity to manage its monetary policy;
 - privatizing some of the banks, insurance companies, etc;
 - limiting the activities of the Development Bank to try to reclaim old granted loans;
 - using open market operations to control inflation via targets for "broad money";
 - limiting credits to state-owned corporations.

High interest rates mean continued problems, which depend on

- continued high government borrowing;
- inflation expectations;
- inefficient banks.

Measures to handle high interest rates include

- more efficient control of banks, including supervision and control of capital adequacy requirements;
- more professional government debt management – for both domestic

and foreign debt;

- stricter rules for Bank of Zambia lending to the government;
- limits to Bank of Zambia's use of cash and liquidity requirements for credit control and intensified the use of open market operations;
- a policy that only licensed institutions may run banking business;
- improving the trust in the internal and external value of the kwacha will help develop a market for government bonds. This will i.a. reduce the sensitivity of the government budget for interest rate fluctuations.

7.5.4 Concluding Comment

The facts presented above show that, in spite of fairly similar conditions at the outset, Uganda has performed much better than Zambia both economically and financially. It may be added that Zambia was expected to perform better than Uganda. The differences in performance can mainly be explained by differences in timing and effectiveness of the implementation of economic policies and structural reforms – especially financial sector reform and market-orientation of monetary and foreign exchange policies. Uganda started its IMF-led structural adjustment programme already during the 1980s, while Zambia waited until the first part of the 1990s.

In spite of the positive assessment, it is, however, important to note that the Uganda situation is quite vulnerable. The budget and current account deficits are still large – at about the same levels as in Zambia. The main reason why these deficits are easier to manage for Uganda than for Zambia is that the international assistance community, including the IMF and the World Bank, heavily assist Uganda financially. This is based on a solid belief in Uganda's development capabilities and has taken the form of large flows of financial assistance as well as of debt relief through the two HIPC Debt Relief Programmes.

To safeguard further success, Uganda has to further improve its macroeconomic policies and performance. It goes without saying that Zambia has to do the same to achieve renewed trust from the international assistance community, which is necessary to get needed financial assistance.

A recent FSSA report on Uganda

A recent IMF Financial System Stability Assessment (FSSA) report (dated January 27, 2003) on Uganda confirms in substance the comments above. The FSSA report states that, among other things, the banking system in Uganda, which dominates the financial system, is fundamentally sound, more resilient than in the past, and currently poses no threat to macroeconomic stability. This is mainly because of the preventive actions taken by the Bank of Uganda. In the aftermath of the 1998/99 banking crisis it closed four banks. It took swift and decisive actions in response to FSAP recommendations. Further, the system is now dominated by large reputable foreign banks that appear to be well capitalized and resilient. A major disruption in donor flows could, however, challenge macroeconomic stability and threaten the financial system.

Despite the progress made in implementing the recommendations of the FSAP, a great deal still remains to be done to further strengthen and support the development of the financial system. This includes the need to:

- fully address the problem caused by the small banks and the risks they potentially pose to market integrity;
- move expeditiously on the stalled passage of the Financial Institutions Bill;
- enact anti-money laundering legislation and put in place a credible framework for monitoring and enforcing it;
- reform the National Social Security Fund (NSSF);
- address the problems of the Uganda Development Bank;
- phase out direct government involvement in micro finance, and
- continue to reform the legal framework, improve banking supervision, and strengthen the payment system.

7.6 Sida/INEC Assistance Evaluation

7.6.1 Frame of Reference and Basic Approach

One obvious approach to assessing Sida/INEC financial sector development assistance (see projects presented in sections 7.1–7.4 above) is to relate to stated priorities within Sida/INEC's own policy. Another relevant approach is to relate to the thinking of the international professional community. Both these perspectives will be used here.

It has to be stressed that the main ambition is to illustrate possible evaluation approaches.

Assessment aspects

A *primary aspect* is, of course, the motive or area of focus/priority of the individual Sida/INEC assistance projects. This aspect relates to the priority criteria etc included in Sida's Financial Sector Policy and/or other similar policy documents.

Another *key aspect* is the *Sida/INEC donor role* as

- a) bilateral donor;
- b) part of a multilateral donor group, or
- c) complementing other institutions such as MIGA.

A *third crucial aspect* relates to the *time-perspective* of the assistance project, i.e.,

- short-term;
- medium-term, or
- long-term.

Still another *worthwhile aspect* for an assessment relates to the *region/country selection* of the specific Sida/INEC project.

A *further aspect* worth taking into account is the *historical, ideological*, i.e., it is obvious that over the years the policy perspective as to the "right" ideological approach to development assistance has changed. This has

partly been a reflection of poor results achieved by the policy in fashion. Partly it has been motivated by changes in the political thinking inside the donor community.

7.6.2 *Assessment Perspectives*

Sida's Financial Sector Policy

According to Sida's Financial Sector Policy, the goal of its financial sector assistance is to contribute to developing efficient, sustainable and competitive financial institutions in the co-operating countries. The goal formulation also includes an ambition to assist the co-operating countries in preventing – as well as managing – financial crises. The main responsibility for the development of the financial sector rests with the government and the various private actors of the cooperating countries.

Sida's role is

- to support the efforts of these parties; apart from providing finance for such efforts;
- Sida has an important role as concerned participant in the elaboration of financial sector policies in cooperating countries, and in the design and implementation of assistance projects;
- Sida may also act as a catalyst for the mobilization of additional resources for project purposes, and as a networking agent for contacts with other foreign partners for coordination and transfer of know-how.

An FSF Recommendation

The main areas of financial sector development assistance can be classified in different ways. A good choice would be the recommendation of the *Financial Stability Forum (FSF)*, which is an international forum for contacts between the IMF, the World Bank, central banks and financial inspection authorities.

FSF has recommended the following areas to be given priority as to financial sector development:

- Macroeconomic Policy and Data Transparency;
- Institutional and Market Infrastructure;
- Financial Regulation and Supervision.

A COWI A/S report

The contents of the thinking of the international professional community is in an illustrative way presented in a recent COWI A/S report (Mistry, P & Olesen, N.E., 2002). A fundamental reasoning on which to assess the value of Sida/INEC efforts can be found in this report, which comments on the history of thinking as to "*the context for Pro-Active Bilateral Activity in inducing FDI flows to LDCs*".

- *Between 1950–80, ODA financed the bulk (65–80%) of physical and productive investment for development.* The results were poor; unsurprisingly, such investment earned low or negative returns. Oddly enough, no serious connection was made in the development community until the mid-1990s between the failure of such investment and the fact that it was

(a) driven by donor governments, while (b) being owned and managed by recipient governments.

- Instead, the conclusion reached *in the 1980s* was that ODA was not suited to financing development investments. Thus, through the 1980s a large part of *ODA flows were diverted to budget and balance-of-payments support to fund structural adjustment.*
- *In the 1990s*, ODA priorities shifted yet again, and *ODA has since financed mainly debt service, humanitarian and emergency assistance, food aid, technical assistance, poverty reduction and social expenditures.*
- *Less than 15% of total ODA now finances productive investment* that creates employment, and increases output and exports, so that LDCs can make a living in an increasingly competitive, global market-oriented, WTO-driven world.
- *ODA now reflects the social preferences and priorities of civil societies and governments in donor countries.* Recipient governments and the private sector in *developing countries* are concerned that it does not address their urgent investment and growth needs. *That role is being delegated entirely to FDI.*
- If a virtuous spiral of inward FDI flows to LDCs is to be started and sustained, it will need official help in the short and medium term. *Experience through the 1990s suggests that multilateral institutions appear to have 'attitude' problems in galvanizing such flows to LDCs*, although their charters suggest that is what they were set up to do. *That leaves the onus on the bilateral side of the official system to do what it can to support FDI to LDCs.*

COWI A/S report recommendations

The COWI A/S report recommends *a number of things that bilateral donors like Sweden can do* – including, of course, getting multilateral institutions to change and become more responsive and effective to mitigate risks and unblock FDI flows to LDCs.

- *In the short-term (0–2 years)*, bilateral donors (like Sweden) can take a number of measures to kick-start and sustain FDI in LDCs. These measures include
 - (a) extending extant risk mitigation capabilities, and
 - (b) encouraging FDI flows to LDCs in other ways as well.
- *Bilateral Donor Initiatives in the Medium-term (0–5 years)* might focus on activities that would take longer to show results than the fifteen short-term options presented in the COWI A/S report. Although these activities might bear fruit only after five years or so, they need to be started now, at the same time as the short-term measures.
- *Long-Term Options for Bilateral Donors to Consider (0–10 years)* might be to consider to bolster the foundations for the future sustainability of FDI flows to LDCs. This would include addressing those barriers to FDI that are presently not being addressed adequately by *either bilateral or multilateral donors.*

7.6.3 Evaluation Comments

Four Sida/INEC projects

GuarantCo can be looked upon as a short-term way of extending risk mitigation capabilities. The project focuses on encouraging local cur-

rency funding of infrastructure projects and reducing investor currency and funding risks by expanding their guarantee capacity for credit enhancement. This can be done both by adding directly to a bilateral donor agency such as Sida's risk capital resources for this specific purpose. But it can also be done by using the 'callable capital' device employed in the MDBs for this purpose without necessarily drawing down immediately on cash budgetary resources when the insurance cover has to be paid out.

Emerging Africa Infrastructure Fund (EAIF). The efforts of EAIF could be seen as a short-term initiative which may be strengthened by increasing direct bilateral participation in private infrastructure funds (such as Sida's participation in the AIG Africa Infrastructure Fund managed by the Emerging Markets Partnership). This initiative could be broadened through more consistent public-private partnership arrangements orienting these funds towards investments in co-operating countries to the extent possible rather than having them concentrate mainly on non-LDCs.

Co-operation with the Swedish Riksbank. This project can be looked upon as a medium-term initiative, where a bilateral donor can make a unique contribution over multilateral donors (whose comparative advantage lies in policies and other more macro and meso functions). This builds on engaging in intensive 'regulatory-partnership' arrangements between financial system regulators in particular donor countries with regulatory agencies in co-operating countries. The aim is to ensure not only that sound laws, rules and regulations are developed, but also that they are applied and enforced.

Financial Sector Reform and Strengthening Initiative (FIRST) could be seen as another medium-term initiative working with multilateral partners and the private sector to develop financial systems and capital markets of co-operating countries more rapidly than is currently being envisaged. If financial markets in co-operating countries are not improved dramatically (with the import of talented human capital as is characteristic of any sophisticated financial market anywhere today) they risk being permanently disenfranchised in a globalised world.

In sum

The comments above have related to four specific Sida/INEC projects. In sum, a general assessment concludes that the projects are well in line with the basic targets of Sida's Financial Policy. To make a qualified assessment of the performance of these projects individually, it would be necessary to investigate them more thoroughly than is requested in the ToR for this assignment. Such an assessment would include special comments as to

- (a) the right proportions between multilateral, bilateral and complementary efforts in the Sida/INEC assistance portfolio;
- (b) if the projects selected – on account of their focus of attention – can be seen as the most effective use of Sida's resources;
- (c) the regional aspect which, of course, could also be included in a discussion of the effective use of Sida's resources.

When discussing these issues, it would be useful to take into account

not only Sida's own policy but also the other considerations presented in this section.

Table 7.2 Assessment Criteria regarding Sida/INEC's Assistance Efforts

Sida Projects	Role	Motive	Area/Priority	Time Perspective	Region
GuarantCo	Bilateral	External risk Mitigation Capability	Credit enhancement through Local Currency Funding	Short-term	sub-Saharan Africa
EAIF	Bi/Multi-lateral	Public private Partnership	Infrastructure Funding	Short-term	sub-Saharan Africa
Cooperation with Riksbanken	Bilateral Capacity	Central Bank	Monetary Policy	Medium-term	Asia/Africa
FIRST	Multilateral/compl	Complement IMF/WB	Develop Financial Systems	Medium-term	sub-Saharan Africa

8. Sida's Co-operation With Other Institutions

8.1 Focus on the Swedish Resource Base

Technical assistance

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

Policy

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. This will enable 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. Further, it enhances the interest of the Swedish financial business community to take part in Swedish development co-operation activities in general and in Sida's development activities within the financial sector in particular.

A resource base presentation

A broad presentation of Sida's resource base can be found in *INEC/Sida, 1997*. Further, INEC/Sida maintains a data base of all institutions, firms and individuals which have expressed an interest in co-operating with Sida in its financial sector assistance.

In a recent Sida consultancy report (*Making Markets work for the Poor, 2003*) the following main partner organizations in Sweden for Private Sector Development are enumerated:

- The Central Bank of Sweden
- The Swedish Financial Supervisory Authority
- The National Land Survey of Sweden
- The Swedish Competition Authority
- Swedish Customs
- The Swedish National Debt Office

- The Swedish National Labour Market Administration
- The Swedish Patent and Registration Office
- The Swedish National Board of Trade
- The Arbitration Institute of the Stockholm Chamber of Commerce
- The Swedish Central Securities Depository
- The Stockholm Stock Exchange
- Statistics Sweden

Forms of co-operation

The most common form of co-operation with the Swedish resource base aims at procuring the relevant expertise for carrying out projects on behalf of Sida. Co-operation can, however, also be organized in other ways:

- The most extensive form of co-operation is to establish a twinning arrangement between a Swedish institution and its counterpart in a developing country;
- Another way, less far-reaching than a twinning arrangement, is to contract a Swedish institution for a specific project or part of a project;
- A further way of co-operation is sending out employees of Swedish financial institutions on short-term missions for Sida.

8.2 International Partners

In the promotion of financial sector assistance, Sida seeks to cooperate with like-minded donors, in particular the Nordic countries. In the European Union, Sida works for the co-ordination of member country policies and sector interventions. Sida also maintains 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
- competence development of Sida staff in these matters.

8.3 The Co-operation Potential

An thorough investigation of the potential for expanding Sida's co-operation with other institutions lies outside the ToR of this Compendium. But hopefully its general discussion of financial sector and policy assistance as well as specific comments on INEC/Sida projects will give an input to and inspire such a discussion inside the INEC/Sida organization.

Appendix 1:

Score Card Indicators – Monitoring The Financial Performance Of Co-operating Countries

I. Introduction

8. *Background and aim*

There is a need for the Sida organization to monitor co-operating developing countries' economic and financial conditions and performance. To make the monitoring effective, it should be done regularly and be based on the same model everywhere, facilitating a comparison of a country with other countries and maybe as well with a benchmark. This is the background for this Appendix. The aim is to start an exercise leading to a "*consensus Score card format*" that will serve as a valuable instrument and input to assistance projects discussions, planning and evaluation inside Sida.

9. *Areas to cover*

The contents of the Score card could be structured as follows:

Selected Indicators including key ratios

The relevant information can be sorted under the following headlines:

1. General
2. Macroeconomy
3. Financial indicators and monetary policy
4. The financial system
5. Institutional arrangements
6. Others including risks

In this ***Score card*** proposal, a preliminary list of indicators is included. This list should be subject for additions, deductions, and comments during the test exercise.

Institutional conditions

Under this heading should be included a short presentation – with a certain historic perspective – of a country's

- financial system; banks, insurance, pension system, etc;
- monetary, fiscal, foreign exchange, and other financial policies;
- legislation and supervision of the financial system;
- IMF/World Bank assistance, including FSAPs, HIPC's, etc.

Stress Testing

This section should present scenarios – based on relevant assumptions – giving results for the financial system as a whole as well as for individual financial institutions concerning

- credit risk;
- exchange rate risk;
- interest rate risk;
- liquidity risk.

Concluding comments

Conclusions based on the information and analysis presented in the Score card as to

- the soundness of the macroeconomy and the government finances;
- the quality and effectiveness of the economic policy management, including monetary, fiscal, foreign exchange, and financial sector policies;
- the soundness, effectiveness and strength of the financial system, including results of the Stress Testing of financial risks, and the quality and effectiveness of government legislation and supervision;
- existence and effects of IMF/World Bank and donor assistance, including FSAPs, HIPC, etc.

Appendices

Relevant extra information should be put in Appendices. This information should include excerpts from *IMF's International Financial Statistics (IFS)*. For IMF's member countries IFS present statistical information based on common definitions, which consequently allows for a valuable country comparison. The relevant IFS statistics cover mainly the following areas:

- Prices and Labour
- International Transactions
- Balance of Payments
- Government Finance
- Exchange Rates
- Fund Position
- International Liquidity
- Monetary Authorities
- Deposit Money Banks
- Monetary Survey
- Other Banking Institutions
- Interest Rates

10. Sources of information

Where and how to find information? The general answer is that a first hand source is the Internet (the Bibliography includes some key web site addresses). But it could and should be complemented by direct contacts with and reading reports from the relevant authorities:

- a) generally: IMF/World Bank/BIS and CIA;
- b) locally: mainly the Central Bank, the Ministry of Finance, and the

Statistical Bureau;

Out of the areas mentioned under separate headings above,

– *Selected Indicators including Key Ratios, and*

– *Stress Testing*

will be given further attention below.

II. Selected Indicators including Key Ratios

1. General	Latest information			Comments		
Population						
Language						
Political system						
Judicial system						
2. Macroeconomy	1980–89, avg	1990–99, avg	2003	2002	2000	Comments
GDP						
GDP/Capita						
GDP growth						
Production/employment structure						
Budget balance/GDP						
Unemployment						
Current account/GDP						
External debt/GDP						
FDI/GDP						
Assistance/GDP						
3.Financial indicators and monetary policy						
			Latest information		Comments	
The Central Bank						
– status						
– direct/indirect instruments:						
– (a) affecting liquidity/credit						
– (b) affecting interest rates (incl Central Bank rates)						
			2003	2002	2000	Comments
Broad money (M2) growth						
Financial depth = M2/GDP						
Inflation						
Interest rates						
– T-Bill rate						
– T-Bond rate						
Exchange rate						

4. The financial system	Latest figure	Comments
Banks		
– number		
– lending to government, %		
– lending to corporations, %		
– loans/GDP		
– NPL(non-performing		
loans)/total loans		
– lending interest rate		
– deposit interest rate		
– banking sector profitability		
– CAR (capital adequacy ratio)		
Nonbank financial institutions		
Micro finance institutions		
Latest information Comments		
Stock exchange		
– number of listed companies		
– market capitalization/GDP		
Money market		
– private institution instruments		
Bond market		
– government/state-owned		
companies securities		
– private corporation securities		
5. Institutional arrangements	Latest information	Comments
CAR (capital adequacy ratio) target		
NPL (non-performing loans) definition		
Loan loss provisioning		
Legal lending limit		
Foreign ownership rule		
Depositor guarantee		
Support/restructuring authority		
Bankruptcy law		
6.Other including risks		
(Comments on i.a., risks, which can be financial, commercial or non-commercial affecting balance sheets, income statements, capital adequacy, credit, liquidity, interest rates, or the currency.)		

III. Stress Testing⁷

IMF missions may conduct stress tests on a country's banking system using data provided by e.g., the Banking Supervision Department of the Central Bank. The purpose of these tests is to examine the potential effects on bank's financial conditions of a set of specified changes in risk factors corresponding to exceptional but plausible events. Both historical and hypothetical scenarios are used. They measure the risk exposure of banks to a deterioration in the quality of

- credit policy;
- exchange rate;
- interest rate, and
- liquidity withdrawals.

If no recent *IMF Stress Testing* exercise is available, it should be possible to make *an own rough Stress Testing* in line with the methods described below.

Credit Risk

Problem issues could be e.g., that banks are likely to be significantly underprovisioned, and/or that the accuracy of reported NPLs (Non Performing Loans) is suspect.

- Relevant scenarios could consider the effects of a variation in the ratio of provisions to NPLs (e.g., by 25 or 50 percent), assuming that the level of NPLs remains unchanged.
- Further scenarios could test the effects of an increase in the ratio of NPLs to total loans (e.g., an increase by 5 or 10 percent), assuming that the level of provisions to existing NPLs remains unchanged.
- A worst-case scenario could consist of calculating the percentage increase in NPLs that banks would be able to absorb before their capital would turn negative (assuming a provisioning rate for these marginal NPLs of 100 percent).

Exchange Rate Risk

Two different scenarios could illustrate this test:

- A scenario based on the largest percentage change in the monthly average US\$ exchange rate over a certain period;
- A scenario based on the hypothetical assumption of a depreciation of the US\$ exchange rate by 20 percent.

Both scenarios could e.g., assume that the net positions of banks in foreign currencies are all US\$ denominated.

Interest Rate Risk

The ability to conduct a thorough stress testing of the interest rate risk may be limited by data constraints. However, the interest rate exposure may in many co-operating developing countries be small because of a

⁷ Cfr IMF, 2001, Ethiopia, Review of Financial Sector Reform Strategy, which includes a comprehensive stress testing exercise of various financial risks in Ethiopia.

short average duration of assets and liabilities and, hence, their frequent repricing. Relevant scenarios could e.g., simulate

- the effects of eliminating the administrative floor on the deposit interest rate by 100 and 300 basis points, respectively. The calculation of discount factors could be based on an assumption, e.g., that the average maturity of saving and fixed-term deposits is say 90 days.

Liquidity Risk

The purpose of the stress testing for liquidity risk is

- first, to determine the exposure of banks to imbalances between their liquid assets and liquid liabilities, and
- second, to evaluate the capacity of banks to withstand a "run" on liquid liabilities.

The stress test could be performed under assumption of say a 20 percent run on liquid liabilities across all banks. In different scenarios, the liabilities could be considered in a narrow (e.g., current and saving deposits only) or a broader (including also fixed-term deposits) sense definition.

This kind of test could, despite limitations in data and methodology, provide important indications regarding key sources of vulnerability among a country's banks.

Appendix 2:

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The list below includes literature used in this Compendium. It has to be added that some of the titles in this Bibliography include comprehensive literature references.

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- *Some key web site addresses:*
- www.regeringen.se – *among others EGDI-publications*
- www.bis.org – *Bank for International Settlements, which among others includes links to central banks*
- www.worldbank.org – *World Bank*
- www.imf.org – *IMF*
- www.cia.gov – *CIA, which among others includes facts on states and governments*

Appendix 3:

Glossary

Below definitions of a comprehensive list of financial terms are presented. The definitions are mainly borrowed from "IMF and the World Bank, 2001, Developing Government Bond Markets. A Handbook".

Asset-liability management (ALM). Risk management approach that examines the combined risks of assets and liabilities over time under different possible future scenarios.

Benchmark yield curve. Yield curve formed on the basis of yields on benchmark securities of selected maturities.

Bonds. Coupon-bearing securities, typically with a maturity of one year or more.

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

Capital adequacy. Provision, typically imposed through regulation, of capital sufficient to cover the risks of doing business.

Cash management. Service responsible for managing short-term outflows and inflows related to debt management.

Central bank liquidity management policy. Central bank policy regarding the management of the supply of bank reserves or settlement balances.

Certificate of deposit (CD). Certificate issued by a bank or thrift institution testifying that a specified sum of money has been deposited with that institution.

Clearing. Matching of orders prior to final settlement.

Commercial paper. Short-term, unsecured promissory note issued by a corporation.

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

Contingent liabilities. Liabilities that are conditional upon predefined events or circumstances.

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.

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 instruments.

Credit-rating agency. A firm that rates the value of financial obligations or the creditworthiness of firms or countries.

Credit risk. Risk that a counterparty will not honour an obligation when due.

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).

Crowding out. Causing issuance by non-government issuers to become more difficult due to a large issuing of government securities that absorb the bulk of national savings.

Currency risk. Risk that a change in foreign exchange rates will diminish profitability.

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

Debt management office. The government office that manages the public debt.

Default risk. Risk that the issuer will not pay principal or interest on schedule.

Derivatives markets. Markets for instruments whose value is derived from other underlying instruments.

Directed credit. Regulations that require banks to direct lending to specific sectors that the authorities deem to be in the public interest.

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.

Disclosure requirements. Transparency requirements for entities issuing securities, to disclose information to the public related to the financial condition of issuing entities, terms of the securities, and other financial matters.

Discount. Difference between the issuing or purchase price and the value at maturity of a fixed-income security, i.e., a reduction from the face value of a financial contract.

Discount window. Central bank lending facility, typically part of an accommodation lending facility. The discount window may lend by actually discounting securities from the borrower, but more often lends on such securities as collateral.

Excess reserves. Deposits held at the central bank beyond those specified by reserve requirements.

Execution risk. Risk that the price of a security may change between the time a quote is made and the time it is acted upon.

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 behaviour 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 intermediation. Interaction of financial market participants, with a financial institution acquiring financial assets (savings) from individuals or businesses and making them available to other parties (investors, governments, businesses, individuals) at a fee (an interest rate).

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

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.

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). FDI is defined as an investment that is made to acquire a lasting management interest (usually 10 percent 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.

Geared. Refers to the same mechanism as "leveraged" (see below).

Hedging. Avoiding the possibility of loss in an asset or a liability by a counterbalancing investment or borrowing. 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.

Interbank market. Market for short-term borrowing and lending between banks.

Interest rate controls. Regulations that impose ceilings on interest rates a bank may charge on its credits or pay on its liabilities.

Interest rate risk. Risk that interest rates may change and thereby reduce the value of an asset or raise the value of a liability.

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

Liquid asset requirement. Regulation that obliges banks to hold assets deemed as liquid. Such assets often include government securities and deposits at the central bank.

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. Further, it refers to actions taken by the individual banks and other financial institutions for the same reasons.

Liquidity premium. Reduction in interest rates achieved in a liquid securities market.

Liquidity risk. Risk that a financial asset will not be able to be converted to cash quickly, and without a tangible loss of value.

Liquid market. Market where buyers and sellers actively trade, so that individual trades are not likely to appreciably move securities prices.

Market maker. A market maker quotes bids and asked prices for securities and normally is prepared to deal at those prices.

Market risk. Risk that changes in market conditions will adversely affect profits or the ability to manage a financial position.

Mark-to-market accounting methods. Accounting methods that regularly and frequently revalue securities or other assets in accordance with market prices.

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

Minimum capital requirements. Requirements to ensure capital adequacy of a financial institution by requiring the maintenance of a certain degree of capital.

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 taxes and expenditures (further, see direct 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, such as bank deposits.

Money markets. Markets in which financial instruments with a term of one year or less, i.e., short-term, near-cash-equivalent securities, are issued and traded. These instruments usually include corporation bills, commercial paper, bankers acceptances, Treasury bills, and negotiable certificates of deposits.

Moral hazard. The risk that the existence of a contract will change the behaviour of one or both parties to the contract, e.g., an insured firm will take fewer fire precautions.

Multilateral trading. Trading between market participants, where there is sufficient price discovery for transactions between participants to be possible.

Nonbank financial institutions. Financial institutions other than commercial banks. These would include such institutions as savings banks, investment banks, insurance companies, mutual funds, and pension funds.

Nonperforming loans. Loans 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, i.e., central bank transactions with market intermediaries to affect general market conditions to meet monetary policy objectives. Such transaction may be outright sales or purchases of securities or repurchase agreements.

Operational risk. Risk that there are breakdowns in internal controls, corporate governance. Or computer systems and events such as major fires or other disasters could cause losses in securities transactions.

Options. Contracts that give the holder the right, but not the obligation, to undertake a specified transaction during a specified time.

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.

Penalty rate. A rate higher than that set for usual borrowing.

Price risk. Risk that the market value of a security may decline below that of its purchase price.

Primary market. Asset market where securities – government, subnational, and private sector – are first issued and sold, typically through some form of tender or auction process, i.e., the market in which primary market instruments (e.g., bonds and stocks) have been initially issued by central banks, banks and corporations.

Private placement. Direct sale of securities by the issuer to particular purchasers.

Prudential regulations. Regulations that are designed as precautions against loss in financial activities. 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.

Public debt management. The process of establishing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities.

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

Real interest rate. The rate of interest excluding the effect of inflation; that is, the rate that is earned in terms of constant-purchasing-power currency.

Reinvestment risk. Risk that returns from a fixed income investment cannot be invested at the same rate as the original investment.

Repurchase agreement (Repo). Transaction recorded as the combination of an immediate securities sale with simultaneous agreements to reverse the transaction in the future. This combination is normally treated in practice as a lending of cash against securities collateral.

Reserve money. Deposits held by banks at the central bank and cash in circulation.

Reserve requirement. The percentage of different types of deposits that banks are required to hold on deposits at the central bank.

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

Risk management system. System to manage the various risks entailed in doing business.

Risk premium. Extra return demanded by investors because of risks associated with an issue.

Rollover risk. Risk that the issuer will have difficulty renewing an issue upon maturity.

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.

Safety net. Possibility of official credit extensions to allay financial crises.

Secondary market. The market in which primary market instruments (e.g., bonds and stocks) are traded after they have been issued by central banks, banks or corporations in the primary market, i.e., asset markets where securities – government, subnational, and private sector – are traded after they have been issued or sold on primary markets.

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.

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

Settlement risk. Risk that one party to a transaction performs, but the other party does not.

Standby lending facilities. Central bank lending facilities available in case of necessity. A discount window could be one form.

Subordinated debt securities. Debt securities that, in case of bankruptcy or other financial difficulty, would be less favoured in payment of principal and interest than more senior securities.

Syndication. Sale of securities through a group with which the issuer negotiates the price of the securities.

Systemic risk. Risk that the failure of one participant may lead to more general financial problems that could affect the stability of the financial system.

Transfer risk. Risk that legal or regulatory barriers may prevent or inhibit transactions.

Transparency. Provision of the objectives of policy decisions and their rationale, data, and information related to monetary and financial policies, and the terms of agencies' accountability to the public in a comprehensible and timely manner.

Treasury bills. Securities issued by a Treasury, usually on a discount basis and for maturities of not longer than one year.

Venture capital. Capital to provide funds for start-up situations ("seed capital") 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 piece of property.

Yield curve. Relationship between the time to maturity of security issues and their yield to maturity.

Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.



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