USAID Policy Paper

Financial Markets Development

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FINANCIAL MARKETS DEVELOPMENT
POLICY PAPER

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FINANCIAL MARKETS DEVELOPMENT POLICY PAPER

EXECUTIVE SUMMARY

The purposes of this policy paper are to (a) describe USAID's policy on financial markets development, and (b) provide guidance on the development of USAID's programs and projects in financial markets.

Effective financial markets are indispensable to the pursuit of sustained, broad-based economic growth. Unfortunately, financial markets development is one of the most complex areas in the development field. Whether financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics.

> The primary role of the financial system in any economy is to mobilize resources for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.
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> Governments in developing countries can and should facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks.
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> Efficient financial markets promote more widespread ownership of assets in a society.A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy.

USAID should promote a system of financial markets that is integrated and relatively undistorted, one that relies heavily on competitive financial institutions, and on policies to facilitate competition. This system should be capable of effectively mobilizing private savings, allocating that savings to investments yielding maximum returns, and maximizing the participation of the general populace. USAID supports developing countries' efforts to (a) design, adopt, and implement policies conducive to the development of efficient, deep, and integrated financial markets, relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (b) build and promote competition between viable private, profit-making financial institutions. USAID can be a catalyst for financial liberalization in developing countries through both the policy dialogue process and project assistance.

USAID can draw upon a broad range of resources to help developing countries build more effective financial markets. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. The primary policy approaches discussed in the policy paper are summarized below.

> USAID too often has designed and implemented projects without adequately

taking into account broader issues involving the financial systems in developing countries. In addition many Missions manage a variety of "credit" projects and other financial markets activities simultaneously. Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities.

Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy recommendations. Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial markets arena. In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, USAID should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment.

Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. USAID should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings.

Over-reliance on directed credit results in often severe misallocations of scarce investment resources that undermines the strength and viability of financial institutions and retards the growth of financial assets. USAID discourages developing countries from relying excessively on directed credit. USAID should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.

In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate. When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, USAID should encourage the host government to adopt specific reforms that permit interest rates to adjust (within an acceptable time frame) to market levels in a deliberate and timely way.

In many cases, the existing legal and regulatory framework restricts the growth of financial techniques and limits the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. USAID should engage in policy discussions and offer technical assistance, as appropriate, to reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions, and streamline and simplify the regulatory and supervisory responsibilities of government agencies.

Strong institutions are essential parts of effective formal financial systems. Improvements in the institutional framework are a means of attaining the objective of broad-based economic growth. The most effective place for USAID

to concentrate its resources, after policy reform, is in assistance to promote the institutional development of financial intermediaries that operate in a free, competitive market and other institutions that operate in the financial system.

USAID has been active in helping developing countries improve their financial systems through the provision of credit. USAID will not take an equity position in a private enterprise. The interest rate to be charged on USAID resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable, and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation. USAID funds provided to financial institutions should carry an interest rate that (a) is at least equal to the cost of local, nonconcessional sources of capital; (b) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (c) is based on the appropriate rate to the ultimate borrowers.

I. INTRODUCTION

Effective financial markets are indispensable to the pursuit of sustained, broad-based economic growth.[*] Unfortunately, financial markets development is one of the most complex areas in the development field. Policy perspectives differ, often sharply, and the costs of establishing and implementing poor policies are high.

The purposes of this policy paper are to (1) describe USAID's policy on financial markets development, and (2) provide guidance on the development of USAID's programs and projects in financial markets.[**] USAID should promote a system of financial markets that is integrated and relative undistorted, one that relies heavily on competitive financial institutions, and on policies to facilitate competition. This system should be capable of effectively mobilizing private savings, allocating that savings to investments yielding maximum returns, and maximizing the participation of the general populace.

II. THE FUNCTIONS AND KEY CHARACTERISTICS OF FINANCIAL MARKETS

The nature and performance of financial systems in developing countries must be judged in relation to an individual country's level of development. Whether these financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics. These functions and characteristics are discussed below.

A. Mobilizing Domestic Resources

The primary role of the financial system in any economy is to mobilize resources for productive investment. The financial system provides the principal means to transfer savings from individuals and companies to private enterprises, farmers, individuals, and others in need of capital for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.[***]

Well-functioning and well-developed financial systems encourage savings and allocate

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[*] A financial system is composed of many financial markets, each offering different types of financial services, serving different sets of customers, and operating in particular geographic areas. Markets can be classified as involving debt instruments, equity instruments, or foreign exchange (or some hybrid involving more than one of these, e.g., letters of credit). The policy approaches and principles described in this policy paper are applicable to the development of all financial markets.

[**] The policy guidance presented in this paper apply to the use of all USAID resources (DA, ESF, PL 480, U.S.-owned local currency) and, when practicable, host country-owned local currency. References to forms of USAID activities (such as "project" and "program") are used interchangeably in this policy paper. The policies presented in this document should be applied in concert with those in the USAID policy papers on Private Enterprise Development (revised March 1985) and Pricing, Subsidies, and Related Policies in Food and Agriculture (November 1982); the Guidelines on Terms of Aid (revised October 1985); and the guidance contained in cables 1986 STATE 259310 and 259314 on the private enterprise local currency lending program described in sections 106 and 108 of the Food Security Act of 1985. Additional guidance on the Housing Guaranty Program is provided in the Shelter Policy Paper (February 1985).

[***] Private enterprises are defined as privately-owned, for-profit business entities. They should be distinguished from private voluntary organizations (PVOs) that are private, nonprofit entities.

resources to higher-yielding investments. Savers can make their surpluses available in investors by, in effect, purchasing financial assets (from a variety of debt and equity claims including entries in a savings passbook from a commercial bank). The financial system mobilizes savings and increases liquidity by providing asset holders with attractive (in terms of yield, risk, and liquidity) financial claims. In the absence of developed financial systems, only investments financed by individual savers or closely-knit groups of individuals would be possible. Many high-yielding investments would not be undertaken and some capital would be invested in activities yielding low returns.

Well-developed formal financial markets offer to savers and investors a variety of short- and long-term savings and investment instruments (often, but not always) through qualified financial intermediaries that enable individuals to make reasonable judgments about the risk and rewards of saving or investing their funds. These instruments effectively package risk and returns so that individuals who wish to participate in appropriate markets can do so, taking into account their own perceived capacity to accept risk. Individuals are able to borrow funds on terms commensurate with the expected risk and return of the investments they wish to make.

Financial systems transform the size, maturity, and risk characteristics of assets. For example, to reduce their risk, investors who wish to finance the acquisition of long-lived capital prefer to borrow at long term. For similar reasons (to reduce their risk), savers seldom are willing to tie up their funds for the long term. Financial systems mediate, inter alia, between the short-term perspectives of these savers and the long-term perspectives of these investors. They do so through (1) direct term transformation of maturities by borrowing short and lending long, and (2) indirect term transformation by buying and selling long-term instruments prior to maturity in secondary markets.

Another way to mobilize domestic resources is through the development of the equity or securities market. Equity financing provides an alternative to debt financing; it also offers new opportunities for investors and for broadening the ownership of economic assets. Expanding popular participation is essential to accomplishing the aims of USAID's policies.

B. The Role of Government

The growing inadequacy of financial systems as countries develop often leads to government intervention in the financial system. To the extent that government involvement in financial systems is misdirected, the development of efficient financial markets will be inhibited and the costs of financial intermediation will be increased. Monetary and financial regulatory policies that stifle financial intermediation, creating "financial repression," are the policies primarily responsible for poorly functioning domestic monetary systems and capital markets, and thus for poor rates of growth. Interest rate ceilings on deposits and loans, combined with inflationary rates of monetary expansion, are the most important policies creating financial repression. Other policies adding to this repression are exchange controls, taxation, credit allocation, and heavy reserve requirements.

Government restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. In contrast, competition in banking and financial intermediation tends to limit the spreads between the interest paid by borrowers and that received by depositors. This serves as an incentive for increasing saving and provides more funds, more cheaply, to investors. This competition, when combined with the adoption of liberalized financial sector reforms,enhances the efficiency with which intermediation is carried out.

At the same time, government plays a key role in assuring that financial markets operate effectively. Governments in developing countries can and should facilitate financial markets

development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks. Such actions would serve to decrease the transactions costs associated with financial intermediation.

Government should play an important role in the area of private ownership and property rights. Private ownership and property rights arrangements are important elements in determining the extent of an individual's participation in financial markets. When private property rights exist, an individual has exclusive right to use and derive the income from . assets, to transfer the assets voluntarily to others, and to be assured that contracts of exchange are enforceable. The absence of these rights makes it difficult for private enterprises and individuals to participate in the financial system.

The proper role of government is heavily conditioned by one key characteristic of financial markets. Unlike markets in goods and most services (in which there is A simultaneous exchange of value), financial markets involve sale and purchase transactions that are separated in time. In a financial market, the product is exchanged for a commitment (for example, in the savings market, a promise to repay savings deposits plus interest), that is, for a promise to act in the future. Although a certain amount of risk is part of any economic transaction (witness the admonition "caveat emptor"), assessing and coping with risk is the essential component of every financial market transaction. The nature of the product involved is in large part determined by the personal characteristics of the actors involved in the transaction. In the early stages of financial markets development, personal judgments of creditworthiness lie at the core of all financial transactions.

The types of policy approaches available could generally be classified in four categories:

(1) "purely" competitive, where government policy is to rely on market forces with limited government involvement even in matters related to supervising, and establishing solvency requirements for key participating institutions;
(2) competitive but heavily regulated for soundness through extensive use of supervision and solvency rules;
(3) administered market, where government intervenes by allocating finance and structuring institutions, but lets markets set prices within these parameters; and (4) managed, where government decisions replace market relationships and the enforcement of supervision and solvency policies is minimal.

The mix or balance of policy approaches could differ in a given market through time and among different markets in a given country. Government policies now generally favor administered or managed systems in many of the developing countries in which USAID operates. Recently, however, several developing countries have liberalized their financial markets. They have implemented reforms to reduce the extent of government intervention through *inter alia* state ownership of banks, directed credit programs, and subsidized interest rates. As a result, financial markets in these countries are less distorted and more integrated; they respond more readily to market signals rather than administrative directives.

C. Efficiency and Depth

Financial markets can be effective to the extent that they are efficient and deep. Governments regulate financial markets to promote efficiency and to avoid volatility.

Efficient financial markets (1) mobilize funds from savings with, at the margin, the lowest opportunity cost (adjusted for perceptions of risk) and (2) distribute those funds to investments that offer, at the margin, the highest potential returns (adjusted for perceptions of risk). Taken together, these are the two characteristics of allocational efficiency. Efficient financial markets also mobilize and allocate funds at minimal cost. This is the characteristic of operational efficiency. It is also important to keep in mind that if there are inefficiencies in the market, then prices or costs would not reflect the real information relevant for financial decision-making (price discovery efficiency).

The depth of financial markets is a measure of their strength: deep financial markets are inherently less fragile than shallow financial markets. A commonly used indicator of formal sector financier depth is the ratio of broadly defined money (currency plus demand deposits) to gross domestic product. A low ratio suggests that the formal financial system is a poor mobilizer of funds; combined with strong demand for funds by the public sector, a low ratio makes credit to the private sector very scarce. In many developing countries, formal financial markets are shallow; relatively few people have access to these markets, and the range of available financial instruments is limited. Friends, relatives, and moneylenders are the primary sources of external finance in a very shallow system. Savings tend to be placed in real assets such as gold or cattle as a store of value. As the system develops, more options are available for yields, maturities, and risks, leading to higher household welfare.

As the system financial develops, prospective investors increasingly can turn to local financial institutions, national financial organizations and, ultimately, international banks and securities markets for additional funds. Each step leads to a more efficient allocation of capital. The resulting increase in the availability of equity and debt funding will enable developing economies to move towards more balanced capital structures of enterprises.

Shallow, formal financial markets do not adjust well to external shocks without collapsing or displaying excessive fluctuations; they are markets in which, *inter alia*, severe market gyrations are fairly common, institutions too often collapse, and "secure" instruments are not, in fact, safe havens for savings. Shallow financial markets also are rather easily subject to manipulation. Low-income developing countries, with their shallow financial markets, have been found to rely relatively more heavily on administrative allocation systems than high-income developing countries.

However, in most of the developing countries in which USAID operates, government policies now appear overly concerned with curbing volatility and inadequately concerned with promoting operational and allocational efficiency. The quest for greater efficiency in the financial markets of developing countries typically means relying more heavily on market forces rather than on administrative controls.

There is a risk due to heightened market volatility involved in the timing and sequencing of introducing liberal reforms. The recent experience of the Southern Cone countries of Latin America is instructive. The main lessons of that experience are:

> financial liberalization should be accompanied by effective supervision of both public and private institutions to avoid fraud, circumvention of sound financial practices, and misuse of funds;

financial authorities should devalue an overvalued currency, before attempting to reform domestic financial markets. Failing to do so will lead to "excessive" borrowing in anticipation of a real devaluation;

financial authorities should consider carefully the likely effects of rapid reductions in existing interest rate subsidies. Depending on the context, a sudden shift to high real rates may trigger widespread defaults and lead to a collapse of the banking system; and

financial authorities should pay particular attention to the sequence the timing of reforms. For example, authorities may wish to liberalize the international current (trade) account before liberalizing the capital account. Otherwise, depending on the context, the result may be destabilizing short-term capital inflows that could stimulate rapid unwarranted appreciation of the domestic currency.

D. Integration

Effective financial markets are integrated in two dimensions. First, integration can be "vertical." Vertically integrated financial systems are those in which the three principal market clusters (formal domestic markets, informal markets, and international markets) are closely linked. Second, integration can be "horizontal." Horizontally integrated financial markets are those in which market interest rates typically array themselves around a basic reference rate.

Vertically integrated financial systems incorporate informal and international financial markets with formal domestic financial markets. Informal financial markets are especially important in USAID-recipient countries because these markets provide the credit and savings mobilization functions for a major portion of USAID's target groups (see section IV.B.6.).

Informal financial markets are highly segmented; moneylenders generally exercise spatial monopoly power. Informal financial markets clearly are "interlinked" markets, in that informal financial transactions spill over into transactions in the local land and labor markets (for example, local money lenders often are members of the landed elite and often hire labor at differential rates depending on the indebtedness of that labor). Although assessing the degree to which these interlinked informal financial markets are integrated with formal domestic financial markets is difficult, linkages between the two markets are greater than may be readily apparent. Informal financial markets have links with formal credit through their lines of credit with commercial and development financial institutions. In addition to serving microenterprises and informal sector enterprises, informal financial intermediaries supply those credit requirements of formal sector enterprises that cannot be met by formal financial institutions.

An effective financial market system also should connect domestic financial markets to international financial markets (and to the related commodity trading systems). The presence of effective financial markets in developing countries will encourage foreign investors to consider providing capital (in the form of both debt and equity) for productive investment. Over time, integration with international financial markets will (1) narrow the differences in the cost of funds between markets in different countries and between different instruments, and (2) spread the risks associated with exchange rate and interest rate fluctuations among a larger number of market participants.

In horizontally integrated and efficient formal financial markets, the reference rate, typically the inter-bank rate, is the market rate of a short-term, low-risk financial instrument. Such an instrument is easily available to financial institutions. It typically provides the basic liquidity for the formal financial system, and central banks often use it to gauge the tightness of

monetary policies. Two markets sometimes are closely integrated because intermediaries operate simultaneously in both; for example, commercial banks operate in both the savings (deposit) and the loan markets. On the other hand, in most developing countries, the government bond market and the market for housing loans probably, not be very tightly integrated.

E. Promoting Widespread Ownership

Efficient financial markets promote more widespread ownership of assets in a society. A larger number of citizens in a developing countries will thereby, have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy. Development of the equity, securities market, for example, provides a means of distributing the ownership of securities more widely among the public, which increases the probability that business ownership will not be confined to a small number of wealthy families or to big industrial-financial conglomerates. Another way to build up widespread ownership is the establishment of contractual savings arrangements through pension funds.

III. STATEMENT OF USAID POLICY AND OBJECTIVES FOR FINANCIAL MARKETS DEVELOPMENT

USAID supports developing countries' efforts to develop financial markets. USAID will encourage these countries to (1) design, adopt and implement policies conducive to the development of efficient, deep, and integrated financial markets, relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (2) build and promote competition between viable private, profit-making financial institutions. The primary source of capital for economic growth should be private domestic resource mobilization. USAID can be a catalyst for financial liberalization in developing countries through both the policy dialogue process and project assistance.

IV. COMPONENTS OF THE USAID POLICY

USAID can draw upon a broad range of resources to help developing countries build more effective financial markets. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. If that assistance is needed to overcome existing constraints in the policy environment, then that assistance should be designed to help resolve, and not compensate for, those constraints. The policy described in this policy paper is Mission-directed, flexible, and closely guided by detailed and comprehensive country studies. It is expected that Missions will concentrate on policy reforms that emphasize greater reliance on competitive, market-based allocation systems and on project assistance to and through private sector institutions. USAID/W will help Missions with technical assistance and other assistance mechanisms where it can.

A. Financial Markets Development Strategy

Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities. This strategy paper should (1) develop a framework for financial markets activities based upon host country conditions and the policy and institutional issues raised in this policy paper, and (2) discuss how existing and proposed USAID-supported financial markets interventions in a country interrelate

under this framework.

A review of USAID's credit projects suggest that USAID too often has designed and implemented projects without adequately taking into account broader issues involving the financial systems in developing countries. For example, USAID often provided credit through public and private development banks, credit unions, and PVOs without exploring the need to mobilize domestic financial resources. USAID projects often implicitly accept interest rate ceilings and administratively determined credit allocation mechanisms as incidental constraints on specific projects. In particular, too little attention may have been paid to the reasons why formal credit was not available.

Many Missions manage a variety of "credit" projects and other financial markets activities simultaneously (involving, e.g., micro-enterprise loans, agricultural credit, mortgage credit, and exchange rate reform efforts). These projects are often channelled through an uncoordinated subset of financial institutions, at a variety of interest rates and conditions. Such efforts may promote a more fragmented domestic financial market than might exist without USAID's assistance.

B. Policy Dialogue

Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial markets arena. Missions must assess realistically the influence they have in encouraging host country governments to adopt sensitive reform packages. It may be difficult to leverage significant financial policy reforms with sharply limited resources or through a single project affecting only a very narrow part of the financial system.

Missions should solicit a broad range of local private sector views to ensure that suggested policy changes are responsive to the broader needs of the private sector as well as to the requirements of economic efficiency, and encourage a continuing dialogue between government and the private sector. In a number of developing countries, important elements of the business community believe that their governments do not adequately understand their needs and their roles in the development process. Missions may wish to encourage host governments to publicly develop a strategy to promote their financial markets through an appropriate set of policies. Such a commitment, as well as a continuing dialogue on matters relating to financial markets development, may improve saver and investor confidence.

Missions should coordinate their efforts in financial markets development with multilateral agencies and other bilateral donors. Multilateral agencies and other bilateral donors are working with many developing countries to help improve their financial systems. Multilateral agencies in particular often are especially well-positioned to advocate politically sensitive policy reforms.

1. Macroeconomic Policies

In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, USAID should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment. If a Mission wishes to initiate or replenish a financial markets activity when the macroeconomic policy framework is inadequate, suitable documentation should clearly demonstrate that the Mission has analyzed the effect of the existing policies on the activity's ability to achieve its purpose. Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy

recommendations. Among the policies that may need attention are monetary policy, fiscal policy, exchange rate policy, import and export barriers, credit controls, and access to foreign exchange. The reform of a particular policy should be undertaken carefully and in concert with other actions.

Missions should encourage developing countries to adopt investment policies that attract foreign investors and increase the contribution of foreign and local investment to economic growth. Opening markets to foreign direct investment provides ways for these countries to diversify their economies and increase their capital inflows. Efforts to attract foreign investment will, if properly conceived, also mobilize local investment. USAID's policies on foreign investment are presented in the Trade Development Policy Paper (July 1986).

2. Encouraging and Mobilizing Domestic Private Savings

USAID should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings. USAID should encourage developing countries to eliminate interest rate ceilings, which inhibit capital formation and individual savings and encourage capital outflow, and adopt policies that allow interest rates to fluctuate in response to market forces.

Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. Instead, they hold more traditional forms of wealth such as land, animals, jewelry, or gold. The result is an aggregate level of savings less than that which could be achieved given improved financial markets policies. Inadequate information, distrust of large and centralized institutions, and various cultural considerations are other important factors that inhibit savers from relying more fully on formal financial markets.

Empirical evidence strongly supports the assertion that the poor in developing countries save. The poor often rely on informal institutions such as investment clubs, savings societies, and rotating credit associations for saving. The informal institutions involved frequently are effective mechanisms for channelling those mobilized savings to productive uses. Mobilization of domestic private savings is dependent on efficient financial markets and profitable uses of the mobilized funds.

Several actions are needed if a savings mobilization effort is to be successful. Two are particularly important. First, effective interest rates paid to savers should be sufficient (normally positive in real terms, that is, adjusted for inflation) to attract an increasing inflow of funds from private savers; artificially low interest rates produce a bias in favor of current consumption and therefore reduce the incentive to save. Second, the services offered by financial institutions must be easily accessible and otherwise attractive to savers.

Combining savings and lending activities of financial intermediaries offers many benefits, and demonstrates the importance of savings to institutional viability. It reduces some costs, including those of establishing credit-worthiness, since financial intermediaries will have better information on and be better acquainted with borrowers through their role as savers. Saver-dominated financial institutions also tend to show steady growth in assets and liabilities, lower loan delinquency, and greater efficiency and financial viability. Borrower-dominated financial institutions tend to show higher rates of loan delinquency, poor rates of growth, perennial liquidity problems, and other weaknesses associated with dependence on external sources of funds.

3. Credit Allocation Policies

a. Directed Credit

USAID discourages excessive reliance on directed credit. USAID should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.*

Administrative allocation mechanisms are particularly appealing to governments of very low income countries where money markets are typically very shallow and highly fragmented (between geographic regions,urban and rural borrowers, different loan purposes, large and small enterprises, and classes of borrowers). Governments generally pursue these mechanisms because of political, social, or distributional considerations.

Over-reliance on directed credit results in often severe misallocations of scarce investment resources that undermines the strength and viability of financial institutions and retards the growth of financial assets. Persistent and usually subsidized directed credit programs typically do not adequately reach their intended beneficiaries, limit the access to (and make more costly) credit of firms not in government-designated "priority" sectors, create "moral hazard" on the part of private investors who operate under the expectation that government support will ward off failure, reward inefficient capital-intensive patterns of investment, require administrative burdens that most developing countries are particularly ill-equipped to handle, and discourage savings intermediation. In addition, the allocation of credit may often be compensating for deliberate or accidental inadequacies in the host government's own policy actions.

b. Government-controlled Interest Rates

When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, USAID should encourage the host government to adopt specific reforms that permit interest rates to adjust (within an acceptable time frame) to market levels in a deliberate and timely way.

In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate.

Countries that have consistently maintained positive interest rates and have an adequate number of institutions that issue attractive financial instruments show a higher rate of growth in their financial assets and have deeper financial intermediary systems than countries that have low and/or widely fluctuating levels of real interest on deposits. Positive market-determined real interest rates generally are associated with the development of sound and self-sustaining financial systems.

Interest rate ceilings often are imposed by governments to protect the borrower from "unscrupulous" lending practices. Yet, lending to large numbers of small and widely dispersed borrowers (e.g., small, rural entrepreneurs) normally involves relatively high administrative costs per loan that cannot be passed on to the end-borrower because of the

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* The "market-determined" or "market-clearing" rate for credit is used throughout this paper, even though its common meaning (the rate at which the supply and demand for credit are in balance with a minimum of government interference) is often not applicable in developing countries where governments exert a great deal of control over financial and related markets.

interest rate ceiling. Consequently, it becomes unprofitable for financial institutions to lend to these borrowers.

Imposing interest rate ceilings, no matter how well-intentioned, often results in reductions not increases in the availability, of formal credit for specific target groups. Local financial institutions handling the subsidized credit can be expected to allocate the credit in accordance with their appraisal of risk and profitability for themselves and thereby improve the quality, but not expand the dispersion, of their loans. Subsidized interest rates also encourage greater use of capital-intensive production techniques by making loans for capital equipment less costly, and, consequently, decrease employment per unit of capital employed.

c. Credit Collateral Requirements

USAID should encourage financial institutions to seek alternatives to fixed and high collateral requirements (such as adopting flexible collateral requirements, charging higher interest rates, lending to groups of borrowers, or establishing special small loan windows).

Formal lending institutions (e.g., banks, credit unions, savings and loans, and finance companies) frequently establish loan collateral requirements that effectively direct credit to favored groups of individuals or enterprises. Collateral requirements often are very high (ranging from 150% to 200% in most developing countries) and may be limited to certain types of collateral (e.g., land). Where interest rates are artificially low, collateral acts as a screening mechanism to discriminate among prospective borrowers. High collateral requirements also may be derived from lender concern about political and economic uncertainty and a lack of familiarity with certain potential borrower groups.

4. Legal and Regulatory Constraints

USAID encourages host country governments to review the legal and regulatory framework affecting their financial systems. USAID should engage in policy discussions and offer technical assistance, as appropriate, to (a) reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions; (b) streamline and simplify the regulatory and supervisory responsibilities of government agencies; and (c) improve the capabilities of regulatory bodies to enforce appropriate laws and regulations.

In many cases, the existing legal and regulatory framework is designed to ensure proper banking practices. However, some controls often restrict or repress the growth o@ financial techniques and limit the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. These controls include, *inter alia*, time limits on deposits; maximum amounts for certain deposits; restrictions on the types of institutions that can receive certain types of deposits; and entry requirements in the banking sector. Some of these measures manifest themselves as implicit taxes on financial intermediaries (see section IV.B.5).

Legal codes and regulations of developing countries are often inadequate on such issues as security of assets, title to property, property transfer, taking possession of collateral on loans in default, and sharing ownership of assets. The result is that under existing laws (a) it is often difficult to broaden the range of financial instruments and securities available in the market; (b) there are limits on when and at what price companies can issue securities in public offers (inhibiting public offerings), and interest that can be paid (discouraging savings);

(c) securities cannot be easily transferred among holders, and often a company has the power to refuse transfer; and (d) investors have inadequate rights and protections.

Proper government regulation is beneficial to lenders, borrowers, and investors. For example, regulation of securities may increase investor confidence in equity shares. Reasonable standards of investor protection, such as adequate accounting standards and rules of financial disclosure, protect securities investors and are critical to the successful functioning of a capital market. Fair enforcement of contracts protects investors, lenders, and borrowers. Deposit insurance encourages individuals to save and deposit their funds. The removal of market entry barriers and the resulting increased competition in providing financial services generally increases the quantity and quality of financial services available to savers and investors. Responsible regulation of private banking and other financial institutions may remove some of the host government's excuses for nationalization of financial institutions and resistance to privatization of state-owned financial institutions.

It should be recognized also that the judicial and enforcement systems are weak and inadequate to settle disputes. Enforcement of rules and regulations can be just only with a fairly administered adjudicatory mechanism including means of appeal.

5. Tax Policies

As part of their financial markets development strategy, Missions should review their host country's tax structures to assess their roles in the development of the financial system. Missions should encourage host governments to change restrictive tax laws and adopt tax policies that provide a suitable tax environment for financial markets development.

In some countries, tax measures inhibit financial markets development and restrict capital formation by increasing the cost of financial intermediation and reducing the financial system's flexibility due to the reduced amount of funds available for lending and, in turn, for investing. Financial intermediation is subject to explicit and implicit tax measures that are not applied to other sectors of the economy. For example, some governments impose an explicit transactions tax on the value of each financial transaction undertaken by a financial institution. Implicit taxes consist primarily of requirements for the maintenance of high reserve levels and forced portfolio investments on low yielding government securities.

In addition, special tax preferences for certain forms of investment discourage savers from investing in those that are not so favored.

A number of tax measures may improve financial intermediation and capital formation. These include, *inter alia*, lowering the explicit and implicit taxes levels imposed on financial intermediaries, and adopting lower marginal tax rates for corporations (which promotes economic efficiency and equity investment, and may reduce capital outflows), and for individuals (which encourages savings rather than consumption). In the absence of lower tax rates, numerous measures can be explored that could encourage greater savings and investment. These efforts will involve substantial policy debate, as financial markets development may conflict with other host government goals, such as raising short-term tax revenue.

6. Informal Financial Markets*

USAID should encourage the host government to adopt specific reforms that increase access to formal sources of credit. USAID should sponsor studies on the nature and functions of informal financial markets. As appropriate, those lessons should inform the design of projects and programs involving formal financial markets.

In many developing countries, the common requirements and practices of formal financial institutions make access to credit and other financial services difficult and expensive. As a result, there remain in place often sizeable informal financial markets. Typically, informal financial markets comprise professional and nonprofessional money lenders (often relatives and friends), local bankers-cum-merchant middlemen, private pawnshops and finance firms, personal and business fixed fund and rotating savings and credit associations, landlords, and the more prosperous agriculturalists. Although heterogenous in composition, these intermediaries share some typical economic characteristics including the predominance of cash transactions, freedom from official registration and regulation, ease of entry or exit, small scale of operations, and the multiple-interest relationship (financial and sociocultural) between lenders and borrowers. They are found in both rural and urban areas, and can be national in scope, such as the curb market in South Korea, or international in scope, such as the Hundi system prevalent throughout South Asia.

Informal financial markets transactions generally take place in an unregulated environment. Some elements of these transactions may be very efficient. They have at best limited connections with monetary authorities (for example, they are not subject to reserve requirements and governments exercise no direct fiscal controls over their activities). However, information of the nature and functions of informal financial markets is woefully inadequate. Important lessons may be derived from careful study of their behavior.

The activities of moneylenders in informal financial markets are often abhorred since interest rates charged in the informal financial markets often are higher and for shorter terms than in the formal markets. Yet,growing evidence suggests that the implicit and explicit costs and difficulties associated with formal credit sources often are higher than are the nominally higher costs for funds obtained in the informal markets.

USAID's assistance to the informal sector has historically been in the form of project-based credit and technical assistance. Although many USAID programs directed at micro-enterprises and informal sector enterprises have demonstrated that these enterprises are reliable borrowers and can be reached cost-effectively, studies have shown that providing credit alone to microenterprises only rarely produced self-sustaining gains; increases in income were short-lived.

Informal sector enterprises often face a policy and administrative environment that contains serious market access and entry barriers. Some macroeconomic policies have a negative impact on informal enterprises and serve as entry barriers to the formal sector. These issues should be addressed within the framework of USAID's assistance to the informal sector.

USAID should also continue to encourage formal financial institutions to serve the same clientele served by the informal financial markets. In the process, the more efficient formal markets gradually displace less effective informal markets. The best examples are those involving the extension of formal financial systems to better serve the growing financial demands of small farmers and small-scale entrepreneurs. This approach depends for its success on the

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* The informal sector refers to those business entities that operate outside formal economic and governmental structures and range in size from the small and labor-intensive enterprise to relatively large and capital-intensive enterprises. Women are widely represented in the informal sector, particularly at the small-scale range of the spectrum.

truth of an assumption that formal financial markets are more effective than informal institutions under appropriate circumstances. Although this assumption is generally borne out over the long run, it may not be correct in some markets in the short run.

To facilitate graduation to commercial borrowing, USAID should foster the involvement of formal financial institutions in the informal system. For example, it may be useful to have a representative from a local private bank involved in an USAID-sponsored informal sector lending program conducted through a PVO. This might facilitate an informal enterprise's graduation from the USAID program to commercial banks by increasing the bank's familiarity with the borrower (and much of that segment of borrowers) while establishing a credit history in which the bank has confidence.

C. Institutional Strengthening and Development

Strong institutions are essential parts of effective formal financial systems. The most effective place for USAID to concentrate its resources, after policy reform, is in assistance to promote the institutional development of financial intermediaries that operate in a free, competitive market and other institutions that operate in the financial system. It should be kept in mind that improvements in the institutional framework are not ends by themselves, but only a means of attaining the objective of broad-based economic growth.

Although particular country situations differ, private sector financial institutions are generally more efficient than public institutions for channelling assistance to individual private enterprises and for mobilizing domestic resources in support of financial markets because they:

- have to depend to a greater extent on their capacity to attract nonconcessionary savings and to engage in new financial activities because of their more limited access to concessionary resources;
- are more innovative in reducing transaction costs and spreading the costs of bearing risks; and
- have been able to better avoid projects of dubious profitability (although sometimes to an imprudent extreme).

USAID should give priority attention to strengthening the private financial system (through which USAID resources should be channelled) and those private institutions that have a reasonable prospect of being self-sustaining. It is preferable to expand the capabilities of existing private financial institutions rather than establish new institutions. USAID should encourage well-run, existing financial institutions to add new types of financial activities to their traditional operations rather than create new institutions to accomplish particular development objectives. Diversification allows institutions to overcome the problems of scale associated with over-specialization, especially in low-income countries with small financial markets.

Greater attention should be directed to structuring assistance to financial institutions to improve their (1) prospects for viability after USAID's assistance has been terminated, and(2) operations in ways that would enhance their own financial strength, growth prospects, and contribution to savings mobilization and credit allocation performance. Examples of measures meriting close attention include cost controls, loan application appraisal techniques, reasonable collateral and other safeguards to protect loan contracts, good collection records, business services, and deposit-taking functions. For self-sustaining viability, financial institutions in developing countries should move toward mobilizing their funds from the domestic economy.

Missions should be alert to the risks of over-emphasizing the supervision of the uses of

credit, as this sometimes results in the neglect of potentially more important objectives of credit projects. External assistance, in the form of technical assistance or staff training (rather than capital for making loans) may help these institutions develop their own capabilities.

In a free market, financial institutions generally organize themselves according to the opportunities they see to meet the different needs of savers and users of funds as well as the changing patterns of savings, fiscal conditions, and institutional arrangements. USAID's programs and projects should be sufficiently flexible to allow for the disbanding of inefficient entities, restructuring, or the merger of institutions as appropriate. For example, institutions may, properly merge or go out of business when there is insufficient market demand to support many separate institutions.

On a case-by-case basis, USAID may help to establish new financial institutions (including special purpose institutions) in areas where private institutions have not been established despite a favorable policy environment and other supporting factors. However, USAID should carefully study each situation and weigh available alternatives prior to proceeding with the new entity. Where existing private financial institutions are capable of performing the desired activity, the establishment of a new trust or trust fund to serve as a financial intermediary for on-lending or equity investment should be avoided.

An unwarranted increase in the number of financial institutions can reduce the success of institutional development. Since financial systems in most developing countries are shallow, special purpose institutions could affect adversely the ability of commercial institutions to attract natural clients. The creation of parallel and costly institutional structures should, therefore, be discouraged, particularly in smaller countries.

Before establishing new financial institutions, USAID should review the existing financial system to determine whether: (1) financial intermediation is being provided at a reasonable cost; (2) financial institutions are providing an appropriate mix of services for market demands; (3) the level of competition among various institutions is adequate; (4) the financial stability and structure of the various institutions is appropriate for their types of financial activities; and (5) experienced management is available.

D. USAID Credit Policy

USAID has been active in helping developing countries improve their financial systems through technical assistance, training, studies, policy dialogue, and the provision of credit. USAID's credit programs and projects (1) support new development finance institutions; (2) help existing banks expand their traditional short-term lending operations to aid medium- and long-term lending; (3) increase the credit resources available for financing priority development activities; (4) eliminate impediments to capital movement among regions or sectors; and (5) open up access to formal credit to disadvantaged borrowers.

1. The Provision of Equity and Grants by USAID

As established in section 635(g) (3) of the Foreign Assistance Act of 1961, as amended, and section V.D. of the Private Enterprise Development Policy Paper, USAID will not take an equity position in any private enterprise[*] Grants to private enterprises in

[*] Section 635(g) (3) of the FAA restricts USAID from directly purchasing equity securities, although USAID does have limited authority to purchase convertible debt securities and may convert them or otherwise obtain equity securities through such means as the enforcement of liens and pledges. Legislative guidance on this subject extends back to the Mutual Security Act of 1954, as amended, and the Development Loan Fund, one of USAID's predecessor agencies.

developing countries are permitted to finance direct training and technical assistance, although such assistance should be programmed in a way that provides competitive access for many enterprises rather than one enterprise.[**]

Owners' equity is important during the start-up phase of an intermediate financial institution (IFI) or other private enterprise as it provides permanent finance with no contractual payments. Owners' equity is the financial stake put at risk by each of the owners, originating from each owner's desire to earn a return on his share of equity higher than alternatives for which he could have used the funds.[***]

A number of reports have characterized USAID's involvement in IFIs as providing "quasi-equity." The quasi-equity instruments usually referred to, such as debentures, are debt instruments. Any confusion between equity and quasi-equity may have arisen because USAID, in the short run, may perform like an owner of equity by insisting that a portion of an IFI's on-lending portfolio (generally the capital available from USAID) contain loans to an USAID target group.

2. Interest Rates to Private Enterprises and Other Ultimate Borrowers

The interest rate to be charged on USAID resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable (it should be borne in mind that use of the U.S. Treasury rate is moderately concessional); and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country.[****] **If interest rates, collateral requirements, or repayment periods are administratively imposed by the government, the terms agreed to in USAID- supported activities will be part of a planned effort to encourage governments to move progressively toward market terms. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation.**

Where practicable, the interest rates and associated fees charged to the sub-borrower by an IFI should cover all of the IFI's costs of lending, such as the costs of funds mobilized or borrowed; the normal premiums for the higher risks of term loans or devaluation risks for loans denominated in foreign currency; a loan loss reserve; the administrative costs of providing loans to end borrowers (which usually are high as USAID generally tries to service the credit demands

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[**] This language refers to private enterprises that are not IFIs. A permitted use for grants to IFIs is discussed in section IV.D.3.a. below.

[***] A donor, such as USAID, has two immediate problems in trying to use its funds as equity. First, a donor's principal motive is not to earn more than an average return on its funds. Second, a donor sees itself as a catalyst to an IFI or a private enterprise, not a long-term member of the board. USAID cannot act as an owner of equity unless it internalizes market-based, entrepreneurial behavior in its involvement in the business entity. USAID would then have to direct its funds to the business entity that offers USAID the best prospects for the highest return.

[****] The opportunity cost of capital represents the value of the best alternative use of the capital, or the opportunity that is sacrificed for a particular use of the capital.

of a large number of small borrowers); any extraordinary costs of non-bank services furnished the sub-borrowers or of supervising the sub-loans; and a reasonable profit margin for the IFI. Interest rates to be charged on USAID's direct loans to private enterprises should be set within the context of this effort.

Special circumstances for concessional assistance are discussed the Private Enterprise Development Policy Paper (section V.D.); however, concessional rates should not be used to encourage private enterprises to undertake activities that are not commercially feasible at market rates. If there is little expectation that a needed product or activity is not commercially viable, then Missions should consider the use of a contracting mechanism to one or several firms to undertake the particular activity, rather than introduce new distortions into the financial market.

Experience shows that in countries in which private business is overshadowed by subsidized state-owned enterprises (SOEs), the financial market is severely handicapped and limited. SOEs often consume much of the total domestic credit available. When USAID extends credit to SOES, loans to SOEs will be at the same rate charged to private enterprises, and are to be provided in the context of the privatization guidance contained in the Private Enterprise Development Policy Paper (section V.F.).

3. The Relationship between Donor Funds and the Cost of Capital to Financial Intermediaries

a. Interest Rates

USAID funds provided to financial institutions should carry an interest rate that (1) is at least equal to the cost of local, nonconcessional sources of capital; (2) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (3) is based on the appropriate rate to the ultimate borrowers. All IFIs (regardless of whether the owners are public or private, joint public/private, or PVOS) should be treated as private enterprises for the purpose of determining interest rates on loans to them because they are selling services in commercial markets and are capable of earning revenue.

Market-based interest rates on loans to IFIs are an essential component of financial markets development. Historically, USAIDprojects that provided low interest (or interest-free) loans to IFIs have developed maintenance of capital value problems in later years. These relatively low nominal interest rates were often combined with moderate to high level of inflation and resulted in negative real rates of interest. Consequently, these projects have built-in automatic financial drains. Interest rate subsidies lead to substantial recurrent cost problems. It is difficult to wean IFIs from subsidies.

A financial institution's usual sources of capital for on-lending are equity capital, debt instruments, borrowings from the Central Bank, and retained earnings. The provision of donor funds provides three initial benefits. First, donor funds provide additional capital to a financial system that has little or no access to external funds and cannot meet capital demand with its domestic resources. Second, the addition of donor funds to the capital base decreases the aggregate cost of funds in the economy. Third, donor funding to the financial sector provides new foreign exchange to the Central Bank.

When a donor provides capital to an IFI at terms below that which the IFI must pay to attract depositors, the IFI may deemphasize its acquisition of deposits from local sources and seek to increase its access to additional donor resources as deposits become relatively more expensive. At the same time, a relatively large spread between USAID's loan terms to the IFI and the on-lending terms may enable IFIs to operate profitably with a significant percentage of

their loan portfolio in arrears or default, and will reduce the pressure on the institution to expand volume and services. This large spread may reduce the IFI's-overall market effectiveness and efficiency, and discourage its aggressiveness in other financial activities. USAID needs to balance this cost against the goal of wanting these IFIs to develop a more aggressive risk profile in their loan portfolios.

USAID needs to make more realistic determinations of the costs of carrying out USAID required activities when developing credit projects. If it is necessary to make adjustments (concessional assistance) in the terms of USAID's assistance to the IFI to hedge agreed-upon risk (although not necessarily the total risk) or cover the costs arising from meeting USAID's programmatic objectives, then the value of the adjustments shall be equal to, but not greater than, the actual costs incurred by the IFI.[*] This will enable the IFI to cover the costs of USAID-sponsored activities and earn a return that, since it is comparable to other returns earned by the IFI, not discourage the IFI from pursuing its non-USAID activities (such as deposit-taking).

If the cost of the institution-building activities (such as training IFI employees) occurs primarily in the early, stage of an IFI project, it may make sense to identify such costs as separate components of a project and to finance these with grant funds, rather than have such costs spread over the term of loan repayment. This approach may be preferred if it is desired that the institution-building activities should proceed before the on-lending activities can generate revenues. Another approach is to provide technical assistance to reduce loan transaction costs in the credit delivery system. A concessional loan would not be appropriate for handling long-term differences in transaction costs between loans to different types of end-borrowers.

If the USAID loan to the IFI is to be concessional, then the grant component of the loan should be identified, analyzed, and its value fully reflected in program or project documents. USAID must justify fully, on a case-by-case basis, the use of loan subsidies (and, as appropriate, grants) to IFIs (including PVOs that act as IFIS).

If the spread between the cost of the funds from USAID and the IFI's on-lending rate is too large, then the IFI receives a windfall profit. If the spread is too small, then the IFI will not disburse the funds, or will not disburse them to the clientele targeted by USAIDThus, the interest spread is a critical financial parameter in an IFI project. Missions may wish to consider lending their funds to an IFI at a floating interest rate if USAID's funds are to be disbursed over a long period of time.

b. Foreign Exchange Risk

The issue of foreign exchange risk presents a special problem. There are certain situations in which private financial institutions are unwilling to accept dollar loans because of the risk of devaluation. They are also afraid that they will be unable to convert their local currency repayments into dollars because of foreign exchange limitations. There are several ways to deal with this problem.

USAID often utilizes a two-step loan that passes its financing through a host country's

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[*] These costs generally include the costs of analyzing and monitoring loans and maintaining a loan loss reserve. The adjustments to USAID's assistance generally include grants, reduced interest rates, or extended grace periods. Programmatic objectives may include making credit available to private enterprises that would not be able to obtain formal financing in the absence of USAID support (additionality), encouraging an IFI to provide term loans, or providing services to a borrower that are not normally part of a loan agreement (such as business advisory services). Determining these costs may be a difficult task; Missions may wish to obtain expert assistance to conduct the appropriate analyses.

government entity (e.g. Central Bank) before the funds are on-lent to ultimate borrowers. The dollar loan is made directly to the government which assumes responsibility for its ultimate repayment and the dollars or the local currency equivalents are then on-lent through the IFI to the ultimate borrowers. This procedure allows internal on-lending arrangements to be structured so that the government can continue to bear all the risk of devaluation, or can pass all or a part of the risk to the IFI and then to the ultimate borrowers. In this two-step process, the interest rate charged to the IFI by the government entity could reflect the real cost of loanable capital to the IFI within that developing country, including the foreign exchange risk. Alternatively, the foreign exchange risk can be shared in varying proportions between two or all three of the participants. It should be noted, however, that in some instances the involvement of the host government in the transaction may discourage private IFIs from participating in the USAID-sponsored activity.

The USAID dollar loan also may be made directly to the IFI. The loan arrangement should be structured to adequately protect the IFI from the high risk of future currency devaluation and to insure the IFI's solvency. Therefore, the credit program should be structured so that all or most of the risk is shifted forward to the sub-borrowers. In high-risk situations this could restrict on-lending to export activities that would earn the foreign exchange needed for repayment.

In both the two-step or direct loan approach, the charges to the end borrower of a loan denominated in local currency may include a contribution to a reserve fund held by the IFI that could be used to offset any deficiency in the local currency loan service receipts in the event of devaluation. Also, in both approaches, the on-lending rate to the ultimate borrower should still be determined by the guidance in section IV.D.2. Many ultimate borrowers do not require dollars. In these instances, they are unwilling to accept the foreign exchange risk associated with dollars. USAID should utilize local currency financing wherever possible in credit projects.

c. Parastatal Financial Institutions

Many governments own or control many of the suppliers of finance in their respective countries. Missions should refer to the Private Enterprise Development Policy Paper (sections V.D. and V.F.) for additional guidance on dealing with parastatal financial institutions. The guidance in section V.D. states that "USAID funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved."

4. Targeting and Guarantying Loans

Targeted credit projects typically enlarge the role of government in financial markets and further distort, or continue to displace, market allocation of capital. Missions should consider such projects (a) after they have determined that there are no policy, institutional, or cultural constraints discouraging the extension of credit to the target group, or (b) as a way of encouraging host governments to correct policy and other constraints where they exist and helping private financial institutions develop some expertise and experience with delivering financial resources to intended target groups (possibly with the concomitant provision of training and technical assistance).

Directed credit projects appear to be attractive mechanisms for assisting USAID's target groups. However, there is some skepticism over whether targeting of USAID loan resources actually accomplishes its intended purpose.

The fungibility of money makes it difficult, if not impossible, to attribute measurable increases in the output or incomes of targeted borrowers to USAID credit activities. In addition, directed credit activities ma@, contravene efforts designed to improve the market behavior and performance of the financial system and mitigate the likelihood that, over time, USAID's directed assistance will be replaced by the capability and interest of the indigenous financial system itself to service the needs of the target group. Great care must be exerted to ensure that USAID's assistance is designed in a way that does not discourage or preempt private sector initiative in this area (especially where this initiative has developed without USAID assistance). Studies have also found that the costs associated with the administration of targeted loans through rural finance institutions, for example, are many times larger than the estimated private lender costs for the simpler task of establishing creditworthiness of borrowers. Finally, the time associated with monitoring and record keeping for the donor diverts the time and skills of the financial institution's staff away from profit-generating activities.

USAID-sponsored guaranty activities also risk distortions of market forces and the efficient allocation of capital. For instance, USAID's objective in a guaranty project designed to redirect credit to rural enterprises (covering the extra risks of lending to the target group), usually requires that credit be redirected away from urban enterprises and towards rural activities. This may reduce much-needed investment funds in urban areas where unemployment rates are extremely high.

Yet, guaranties may be appropriate when the general policy and institutional environment is supportive and lenders retain their traditional inhibitions in developmentally important areas (such as encouraging new, higher-risk, longer-term lending, or lowering or changing collateral requirements). Since guaranty programs should facilitate break-throughs in new lending patterns and are not meant to substitute for unaddressed structural inadequacies in financial markets, the case for their introduction must be well-justified and the size and duration of such programs should be limited.

5. Lending through PVOs and Nonprofit Entities

USAID should rely upon PVOs and non- or not-for-profit groups for lending only when private, for-profit financial intermediaries capable of performing the desired activity do not exist, or when PVOs are used as part of a Mission's financial markets strategy to involve the private financial banking system in on-lending to the target group (in a way that does not discourage or preempt private sector initiative in this area). PVOs or other non- or not-for-profit groups are not to be utilized for making equity investments. PVOs should lend at rates consistent with the guidance stated in section IV.D.2.

Some private voluntary organizations (PVOS) have special advantages in working with micro and small-scale enterprises because the PVOs are flexible and in touch with the poor and their problems. Some PVOs can offer financial assistance to enterprises or individuals not reached by formal sector credit markets and can collaborate with banks and local financial institutions to establish credit systems for those needing small or short-term loans. The use of PVOs and a combination of technical assistance and credit are often effective in reaching USAID target groups such as rural enterprises and women.

Establishing financially autonomous institutions to manage credit, training, and technical assistance programs and projects often is an important component of a good financial markets development project. To the extent that PVOs act as IFIs, they should follow lending and repayment collection practices based on market-oriented and capital preservation principles. In situations where there has been no experience with lending to micro and small-scale enterprises, PVOs can demonstrate to financial institutions how lending to the poor may be profitable.

Where feasible, USAID-financed projects should include mechanisms to graduate beneficiary enterprises from utilization of resources provided from PVOs to borrowing from formal sector institutions.

E. Financial Training and Standards Development

USAID should emphasize to a developing country's public and private sectors the importance of (1) adopting adequate training requirements for accountants and auditors; (2) establishing generally accepted accounting principles and auditing standards, and comprehensive uniform financial reporting and public disclosure requirements; and (3) maintaining a proper balance between self-regulation and public regulation of these matters. USAID also should support efforts to train accountants, auditors, and others involved in finance. Adequate accounting, financial analysis and reporting, and auditing are critical to a properly functioning market-based financial system. Without these skills, it is not possible to determine the true position and profitability of enterprises. Accounting and auditing principles should be standardized and widely accepted.

F. New Financial Instruments and Institutions

As economies develop, credit demands become more complex and the expanding demand for physical capital requires credit that varies by the length of time required (short-, mid- or long-term) as well as the end-use (consumer, investment, risk capital, venture capital, mortgage, etc.). Where delivery and marketing systems and government policies are satisfactory, formal financial institutions generally evolve to satisfy these more complex needs. However, in most developing countries the strength of demand for different types of credit exceeds the financial sector's capacity to diversify and develop the institutions needed to respond.

As appropriate, Missions should develop and pursue a policy dialogue agenda with host governments that encourages development of capital markets and associated intermediaries in, for example, equity securities. In most poor developing countries, securities markets are effectively absent and their development is not a high priority. Capital market intermediaries (primarily primary and secondary securities markets) are often inadequate for the development of new equity instruments and the transfer of equity shares and bond instruments. Even in some relatively sophisticated countries securities markets are extremely thin: transactions in stocks are negligible; medium and long term bond markets are shallow; and institutional investors are not a major presence. Therefore, capital markets have little opportunity to contribute to savings mobilization and economic growth and enhance the country's participation in international capital or equity transfers. A sustained effort to develop securities markets may be warranted in many USAID-assisted developing countries. Some preliminary work to promote the concept of securities markets development may be useful in the poorer developing countries.

USAID encourages developing countries to develop and utilize new debt and equity instruments for directing scarce capital resources into productive investments. Among the instruments and techniques for mobilizing capital for productive investments that should be explored are commercial paper and bonds, term lending[*], debentures, government securities,

[*] Private lending institutions in many developing countries avoid making long-term loans because they lack access to resources with the longer maturities appropriate for supporting term lending. They also consider such lending to be less profitable or more risky than alternative investment opportunities, and often face an uncertain policy environment. Other major factors that limit the ability of these financial institutions to undertake long-term financing are the institutions' own shallow resource bases; preferences for fast recovery of funds; inexperience with term loan instruments; and limited local

trade (or supplier) credit, debt-equity swaps, mortgage bonds, agricultural production contracts, variable interest rate structures, and deposit insurance. These and other financial instruments enable the financial market to spread risk among a variety of instruments, thereby reducing exposure to market volatility, and to be more flexible and responsive to the users of financial instruments.

Missions should ensure that the proper policy conditions exist for venture capital activities prior to, or in concert with, the provision of any support to venture capital firms. Funds lent to venture capital firms should be at market rates; grants or equity contributions are not permitted.

In some USAID-assisted developing countries; USAID may wish to explore activities involving venture capital. These activities may wish to emphasize the policy environment. Among the impediments that should be addressed in support of venture capital activities are: (1) the lengthy government approvals process required for the start of new ventures; (2) unfavorable tax laws; (3) failure to give adequate legal recognition to venture capital firms; (4) requirements for court or government approval to merge or sell out the company when successful; (5) absence of an adequately organized or liquid securities market into which the venture capitalist may sell his shares; (6) government control of when public offerings may be conducted and at what price; and, for foreigners, (7) restrictions on repatriation of profits.

An alternative to fixed-rate loans for venture capital activities may be variable-rate loans based on the internal rate of return or equivalent financial performance of the venture capital enterprise. This arrangement would reflect the relatively high degree of risk and uncertainty attendant in venture capital approaches in developing nations, and would avoid burdening the venture with a large fixed obligation that might inhibit risk taking.

USAID supports the use of debt/equity conversion programs as an important financial markets instrument.

Debt, equity conversions, or the capitalization of foreign obligations, are gaining considerable momentum in business and policy circles. A debt/equity conversion (commonly referred to as a debt equity swap) is essentially, through a series of complex and interrelated steps, the conversion of an external debt obligation into an equity stake in a company.

Debt-equity conversion programs contribute to economic growth in several ways, including the promotion of policy reforms that support growth and investment, and the reduction or containment of immediate foreign exchange debt servicing burdens. Use of debt/equity swaps also has the effect of increasing levels of private investment in productive enterprises, facilitating financial arrangements for privatization, encouraging the return of flight capital, and rebuilding confidence between commercial banks and debtor countries.

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markets for large, long-term financial assets. Furthermore, the unreliable accounting practices commonly followed by many private enterprises contribute to the reluctance of commercial financial institutions to extend credit to new and unfamiliar entrepreneurs.

The cumulative impact of debt/equity swaps depends on available opportunities for investment in developing countries, the depth of their capital markets, and the ability of local economy to absorb additional credit.

ANNEX

GLOSSARY OF FINANCIAL MARKETS TERMS

Asset Anything that is owned by an individual or business that has commercial or exchange value. Assets may consist of specific property or claims against others, in contrast to obligations due others. The principal asset categories are: *current assets*, the sum of cash and short term investments, accounts receivable (trade and other), merchandise inventories, advances on merchandise, and listed securities not in excess of market value; *fixed assets*, permanent assets required for the normal conduct of a business (furniture, land, buildings) and generally referred to as illiquid or capital assets: and *deferred assets*, assets that are not, in the ordinary course of business, readily convertible into cash, subject to current settlement.

Assets may also be classified as tangible and intangible. *Tangible assets* include physical or material assets, e.g., real estate, buildings, machinery, and cash, as distinguishable from *intangible assets* that represent rights or economic benefits that are not physical in nature, e.g., goodwill, patents, franchises, and copyrights.

Bankers' acceptance A bill of exchange drawn on or accepted by a bank to pay specific bills for one of its customers when the bill becomes due.

Collateral Security given by a borrower to a lender as a pledge for payment of a loan. Principal kinds of collateral are real estate, bonds, stocks, and chattels. Although any kind of property that has a ready and stable market may be employed as collateral, the collateral value of different kinds of property is subject to wide fluctuation depending upon the readiness and steadiness of the market and the ease of title transfer.

Commercial paper All classes of short-term negotiable instruments (notes, bills, drafts, checks, deposit certificates, and acceptances)that arise out of a commercial transaction.

Common Stock Securities that represent an ownership interest in a corporation. That part of the capital stock of a corporation that represents the last claim upon assets and dividends.

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

Credit controls-Quantitative and qualitative control exercised by the monetary authorities over the volume and nature of credit and over interest rates. These controls can affect the quantity and cost of credit available to domestic and foreign borrowers in the country's capital markets, and can strongly influence the direction of the national economy.

Debenture A classification for all forms of unsecured, long-term debt whether for corporate or civil obligations, although it is usually applied to a certificate of debt issued by a corporation.

Equity The net worth of a business, consisting of capital stock (preferred and common), additional paid-in capital, retained earnings, and, occasionally, certain net worth reserves, and/or adjustments. When used in a financial sense, equity means the value of property beyond the amount of all claims and liens against it.

Financial markets The money and capital markets of the economy. Money markets buy and sell short-term credit instruments generally for working capital to enterprises that require funds to manage their current affairs. Capital markets buy and sell long-term credit and equity instruments generally for fixed or permanent capital formation that enables businesses to be established or to expand their operations.

Foreign exchange rate The price of one currency in relation to that of another, or the number of units of one currency needed to purchase one unit or another.

Intermediation The investment process in which savers and investors place funds in financial institutions in the form of savings accounts and the financial institutions in turn use the funds to make loans or other investments.

International financial markets An all-encompassing term that refers to all international or multinational markets for short-, medium-, and long-term securities and loans, forward and swap contracts, financial futures, and foreign currencies.

Letter of credit Instrument by which a bank substitutes its own credit for than of an individual, firm, or corporation, to the end that domestic and foreign trade may be more safely, economically, and expeditiously conducted.

Loan A business transaction between two legal entities whereby the lender agrees to "rent" funds to the borrower, to be repaid with or without interest.

Net worth The owner's equity in a given business, represented by the excess of the total assets over the total amounts owing to outside creditors at a given moment of time.

Preferred stock Corporate stock whose owners have some preference as to assets, earnings, etc., not granted to the owners of common stock of the corporation.

Primary markets The "market" in which financial assets (i.e., stocks) are originally issued.

Risk The possibility of loss; specifically, the chance of nonrepayment of debt.

Secondary market The "market" in which primary market instruments (e.g., stocks) are traded after they have been issued by corporations in the primary market.

Securitization The broad process whereby capital financing occurs through securities issuance rather than bank financing.

Subordination Acknowledgement by a creditor, in writing, that the debt due him from a specified debtor shall have a status inferior or subordinate to the debt which the debtor owes another creditor.

Term loan A loan provided for an extended period of time, generally with a maturity greater than one year and for such purposes as an increase in working capital or the purchase of equipment or other fixed assets.

Trade credit Credit on goods purchased by a company from its supplier (also called supplier credit or accounts receivable credit). The use of trade credit brings different types of companies, including many nonfinancial companies, into the credit system and may, in fact, increase a firm's sophistication in the uses of credit.

Trade finance The financing, usually characterized as short-term, of import-export trade transactions.

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

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

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