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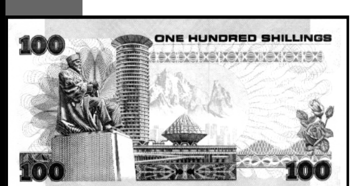

Efficient Capital Markets

A Key to Development

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Efficient Capital Markets

A Key to Development

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Summary

THIS STUDY EXAMINES USAID activities to promote creation or strengthening of capital markets in developing countries. There are two basic conclusions.

First, USAID has been successful in promoting capital market development. The general approach promoted by USAID—emphasizing the strengthening of the government regulatory institutions—is sound, and USAID has been able to contract capable expertise to carry out such projects.

Second, an efficient capital market is an important ingredient of a successful development strategy. Though the effects of strengthening of capital markets on poorer strata of society are indirect and long term, they also have important consequences in generating increased investment and creating more productive employment. Moreover, the failure to provide strong oversight of capital markets, evident in the Asian financial crisis of 1997–98, also can have severe adverse consequences for poor people.

The conclusions are based on fieldwork led by teams from USAID's Center for Development Information and Evaluation. They reviewed recent USAID-funded capital markets projects in India, Kenya, Morocco, the Philippines, and Romania. A CDIE researcher also studied an earlier USAID capital market development effort: creation of investment banks in Central America in the 1960s.

Specific lessons learned from the study include the following:

1. Effective capital market development should not be left to the private sector. Government oversight is needed to prevent market intermediaries from maintaining monopolistic arrangements that lead to high transactions costs, to an atmosphere permissive of self-dealing and rigged transactions, and to insufficient flow of information to potential investors.

2. Donor support should aim primarily at strengthening this governmental regulatory framework. Payoffs to such

support are likely to be much higher than direct support of individual enterprises or investment houses.

3. Capital markets projects are unlikely to stimulate economic growth where economic conditions are unfavorable. Inflation, large government budget deficits, and uncertainty about the path of future government policies all deter investment. Capital market reforms will not produce growth in a stagnant economy. Rather, such projects are best suited to rapidly growing economies where existing capital structures are limiting investment, and where firms are actively interested in additional financing.

4. In the longer term, creation of long-term debt markets is essential to reduce the risk of financial crises, such as the recent Asian experience. That will require improvements in government policy to eliminate inflationary expectations and reduce crowding out by government.

1 Capital Markets And Economic Development

A Tale of Two (Or Three) Cities

SEVERAL DAYS A WEEK, one can travel to Washington from Bombay with a stopover in Amsterdam. Amsterdam and Bombay have much in common. They are both collections of islands that human effort, through landfills and swamp drainage, converted into cities. Each is its country's leading port, and a bustling commercial center. They are both located in countries that are among the most densely populated in the world. At 986 persons per square mile, population density in the Netherlands is about 50 percent higher than in India. The scale is different, though. India is a vast country, while the population of the entire Netherlands is about the same as the city of Bombay alone.

The two airports do not differ dramatically from each other. Each has the size, bustle, metal detectors, and jetways common to today's international traveler. The latest technology in aircraft is available to move people from one airport to the other. Both are about the same distance (12–16 miles) from the center of the city. It is on leaving the airport for the city center that the dramatic differences appear.

From Amsterdam's airport, one can take a commuter train and be at the center of the city in 20 minutes. The ride is quiet and comfortable. It passes through a mix of residential and industrial areas. Most of the residences are low-rise apartment buildings, but with an abundance of well-maintained green space and parkland. Some factories can be seen in the distance, but the more common workplaces are high-rise buildings where armies of white-collar workers directly produce nothing tangible. Like office workers elsewhere, they talk on the telephone, go to meetings, and write words on paper. The result of these efforts is sufficient for the average Dutch worker to earn about $50,000 a year. On arrival at the center of the city, one can stroll along the streets with the same feeling of quietness, of clean, well-maintained buildings and streets, of a general pleasantness and "uncrowdedness."

The contrast on leaving the Bombay airport is stark. The taxi ride to downtown takes an hour unless traffic is bad. (A new traveler might try to take a train, but massive overcrowding would dissuade most from doing this a second time.) Most of the trip is through areas that scream extreme poverty. The basic vision that assaults the senses is of massive overcrowding, of taxation of the infrastructure to the breaking point. Too many cars, too many people, too much pollution, and too much poverty. Some sights strain the imagination, as seeing women dressed in immaculate saris emerging from labyrinths of hovels on tidal mud flats. The bustle of the individuals on their way to work is no less than one sees in Amsterdam. The first impression is that people work as hard in Bombay as in Amsterdam. Yet the average Bombay worker earns about $1,000 per year. (That is about 50 percent more than the average for India as a whole.) What explains the difference in the physical infrastructure that faces workers in these two cities, and the difference in productivity of the workers?

Until recently, any comparison of this sort between Amsterdam and Bombay would have seemed unreasonable. After all, the Netherlands was probably the most advanced country in the world three centuries ago. The state of its infrastructure reflects accretion over long periods of time. This is true, but the experience of some other Asian countries suggests that centuries may not be needed to make the transformation. One may also fly easily from Bombay to Singapore, another island city where much has been reclaimed from swampland. Until the 1860s, Singapore was a fishing village. Even as recently as India's independence in 1947, the differences in standards of living between Singapore and Bombay were not stark. Singapore had much of the overcrowding, slums, poor water, sewerage and municipal services characteristic of Bombay today. Yet in a generation, it has made strides that make it comparable to Amsterdam in municipal amenities. It has a higher per capita income than the Netherlands and a longer life expectancy. How did such a rapid transformation occur? Why has Singapore been able to make it, and why has Bombay not done so?

Issues of the amount of capital that the society invests and — more important — the efficiency of the capital investment process seem to lie at the heart of the answer to this question. The capital market is the medium through which investment is allocated among alternative uses in a market economy. In such an economy, the capital market is the investment planning office. It decides how many resources will be available for investment by firms throughout the economy; how much, and at what cost, will be available for infrastructure investment; which companies will be able to expand and which will not. In India, the government, through central planning, sought to play this role for decades. The USAID capital markets development project sought to assist in the transfer of this function from the government to the marketplace.

The Role of the Financial Sector in Development

The area of money, banking, and finance has long fascinated economists and nonexperts alike. There is an old adage, "not one man in ten thousand understands the monetary question—and you meet him every day." The adage captures both the esoteric nature of finance and the continual production of theories or ideas about how new approaches to finance will yield great results.

Experts have long agreed that financial resources are a key factor in economic development. The large differences in average income levels among countries relate much less to differences in the natural resource base, including quality of land, than to differences in the man-made resource base. This stock of man-made capital includes machinery, equipment, and buildings used for productive activities, but also economic infrastructure, including roads, electric power grids, and communications systems. In countries where the supply of financial resources has made these capital items abundant, they allow the society's workers to be highly productive, and therefore allow high levels of income.

The differences between rich and poor countries are evident in the structure of capital stock. In poor countries, land represents most of the capital stock. In rich countries, land's relative value is dramatically smaller, and most capital consists of man-made structures. Vast differences in nonmaterial aspects of the two types of societies—notably in the knowledge base of the workers, and in the institutions of the society—are also an important part of the reason rich countries are more productive.

In developed market economies, financial markets play the pivotal role in intermediating between the society's savers and its investors. They are the vehicle for moving savings into investments in productive activities, both long term and short term. In low-income countries, banks tend to dominate financial markets, with the market for long-term capital generally undeveloped.

An efficient financial market will stimulate economic growth by encouraging savings and by channeling it into the most productive investments. In earlier times, economists were frequently more concerned about the quantity of investment than the quality. Development experience since the 1970s, however, has demonstrated that quality is critical. Countries such as India and the members of the Soviet bloc have allocated high shares of their gross national product to investment, yet produced only modest results in economic growth. Investment has flowed to the wrong sectors, or used the wrong technologies, or was used for unproductive activities.

The role of the financial sector in economic development has been a subject of some controversy. Some economists have maintained that it is the "real" sectors (i.e., those producing goods and nonfinancial services) that are the critical determinants of economic development, and that the financial sector grows and evolves in response to conditions in those sectors. More commonly, though, economists have come to the view that the state of the financial sector affects the possibilities in the rest of the economy, particularly with respect to the quality and quantity of investment. As Levine (1997, 689) concludes in his survey of financial markets and development:

> A growing body of work would push even most skeptics toward the belief that the development of financial markets and institutions is a critical and inextricable part of the growth process and away from the view that the financial system is an inconsequential sideshow, responding passively to economic growth and industrialization. There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change. Moreover, cross-country, case study, industry- and firm-level analyses document extensive periods when financial development—or the lack thereof—crucially affects the speed and pattern of economic development.

The Asian Financial Crisis

The Levine survey was written shortly before the July 1997 devaluation of the Thai baht, which set off a financial panic throughout much of Asia. South Korea, Indonesia, and Malaysia were, along with Thailand, the most severely affected countries. All four countries had been receiving massive amounts of foreign capital, mostly in the form of (short-term) bank loans. Except in Indonesia, where foreign banks lent directly to enterprises, most of the foreign lending was made to local banks. The banks re-lent in local currency, assuming the foreign-exchange risk. The devaluation thus immediately threatened their financial position.

Faced with the prospect of future financial problems for their clients, foreign banks refused to roll over loans. There ensued a scramble to withdraw capital from these countries before conditions worsened. This exacerbated the original problem. Exchange rates fell sharply after central banks ran out of reserves. Banks and firms with large exposure of foreign debt might have become bankrupt overnight because of their losses. If not, they were potentially bankrupt over the longer term because the loss of operating capital as banks called in loans threatened their capacity to continue to operate.

The financial crisis was severe in all four countries. In Indonesia, worsened by an emerging succession crisis, it was catastrophic. In all four countries, the cascading bankruptcies led to severe recessions, mass unemployment and dramatic falls in overall production. In 1998, gross domestic product fell by 14 percent in Indonesia, 9 percent in Thailand, 7 percent in Malaysia, and 6 percent in South Korea.

Fortunately, the Asian financial crisis did not prove to be long lived. All the countries began their recovery by late 1998.

Korea recovered fastest, growing by 6.5 percent in 1999, and only Indonesia was expected not to have recovered to the precrisis level of production by the end of 2000.

The causes of the Asian financial crisis are still being debated, and its consequences are still being analyzed. The crisis did underscore the vulnerability of financial markets in many developing countries to loss of confidence by foreign investors. Two conclusions have been most widely accepted as lessons from the crisis. First, prudential supervision of banks in countries going through financial liberalization is critical. Supervision of commercial banks needs to be strong to ensure that weakness in one or a few institutions does not bring down the entire system. Second, developing countries that have heavy foreign capital inflows should ensure that such flows are diversified, with substantial shares in the form of long-term capital and equity investment, rather than in short-term lending that can reverse itself quickly.

Financial Markets And Capital Flows

While efficient financial markets are important for efficiently allocating a country's financial resources, they can play a second role that is particularly important for developing countries—that of providing a means for attracting capital from abroad.

Although the withdrawal of foreign investors from emerging markets during the Asian financial crisis was substantial, that in no way changes the fundamental factors that led to sizable foreign interest in these markets before the crisis. There are two reasons in particular.

First, the rate of return on investment in developing countries that follow good policies is likely to be higher than in other parts of the world. As Sachs and Warner, among others, have shown, these countries are likely to be the fastest growing economies in the world, eventually catching up with (or "converging") with the industrial countries. This rapid growth is sure to be accompanied by high rates of return on investment—higher than those available in developed countries. This will create the incentive for substantial flows of investment from the capital-rich industrial countries. Some of the capital inflow to these countries can come through direct foreign investment, but some should come through portfolio investment in both equities and debt. Countries will need efficient capital markets if they are to provide a channel for such inflows.

Second, international portfolio diversification is a useful means for reducing risk. Even investment in relatively risky foreign assets can simultaneously lower the risk to an investment portfolio and raise its expected rate of return. (Diversification of investments reduces overall risk.) Portfolios of pension funds, insurance companies, and other institutional investors began to diversify internationally during the past decade. There is potential for those flows to become massive during the next decade if the supply of investment assets in developing countries increases sufficiently. Again, development of efficient capital markets is the critical factor.

Financial Markets And USAID's Mandate

Even if financial markets are important to development, there still remains the question whether it is an appropriate area of activity for USAID. Many aspects of finance would not appear to be a priority for the Agency, given its interest in poverty reduction. Perhaps financial markets are important, but it is not immediately obvious why this quintessential market-based area should not be left entirely to the private sector. Thus, the argument that the poor will be helped if the wealthy are helped has been derided as "trickle-down economics." Nevertheless, some aspects of financial markets activities are directly relevant to alleviating poverty. First, there is the obvious connection that developed financial markets are associated with low levels of poverty. Countries with large numbers of poor people have undeveloped financial markets, whereas countries with little poverty have well-developed financial markets.

At a less sweeping, more concrete level, two obvious linkages exist between the welfare of poor people and development of capital markets. The most obvious one is through the creation of productive employment. As discussed earlier, workers in higher income countries are paid high wages because they are very productive, and they are productive in part because they use large amounts of capital in the form of specialized equipment. This dimension was explored by Buttari and Manarolla of USAID's Global Bureau in 1997. They showed that increased financial flows through the Jakarta stock exchange led to a substantial increase in industrial employment in Indonesia.

The second linkage between poor people and financial markets is as consumers of products and services. Capital investment makes production more efficient and therefore cheaper; it may also provide access to goods and services that would not otherwise be available. This is most obvious in basic services such as water and electricity, where long-term finance is essential to rapid expansion of coverage in developing countries. Some academic research has suggested a third linkage, relating development of capital markets to democratization and good governance.

That linkage is as follows: Regardless of the desirability of working generally in financial markets, there are specific aspects of such markets that seem to be of particular importance to poor people. Such niches, where USAID has long worked, include small-farmer agricultural credit, financing for small and medium-size enterprises, and—for the last decade or so—microfinance.

Finally, drawing on the experience of the Asian financial crisis, one could argue that developing sound financial markets is of considerable importance to poor people. Expansion of financial markets may not help poor people in any large or tangible way, at least in the short term, but financial market collapse certainly hurts poor people immediately and substantially. A 10 percent drop in real income is a major inconvenience for people in any economic class; for the poorest, it can be catastrophic.

Earlier Financial Market Evaluation Findings

The ideas of donors (who have money to spend) and academic thinkers (who have ideas but little money) about how the financial sector can be used to promote development have changed over time. Evaluation findings from previous donor projects provide one source of information about what works and what doesn't, and so provide one important component of changes in approach. Nevertheless, two other sources of ideas or information are also important.

First, theoretical developments in economics can provide new insights that lead to reshaping the ideas about how financial systems affect the rest of the economy and impact on people's lives. Second, empirical research into the operation of financial systems and institutions also allows increased insights that allow donors to design better financial sector projects. Such work can help adjudicate between alternative ideas about human behavior that are equally plausible in theory but quite different in the results they produce in practical experiments.

In sum, the quality of USAID projects, and USAID's ability to draw proper lessons from experience, depends not only on evaluation of past projects but also on keeping current with theoretical developments in economic thinking and on staying abreast of research conducted on related issues. All three aspects of learning have been evident in USAID's changing approach to financial sector development over the past several decades.

One of the earliest cases of attempting to draw general lessons from USAID activities in financial markets was in 1972, when the Agency conducted a review of its programs for credit to small farmers. Small-farmer credit programs, usually providing low-interest-rate loans, had been a common feature of USAID programs during the 1960s. The common belief at the time was that low interest rates were necessary because small farmers could not "afford" to pay market rates of interest.

The review uncovered two serious problems with preferential interest rates. First, lending institutions following this approach were unsustainable because their interest collections could not cover their costs. Consequently, they gradually became decapitalized and unable to provide continuing support for the financial needs of small farmers. Second, the subsidy attracted more potential borrowers than available funding could attend. The usual response of bankers to this excess demand for loans was to find some way to ration the available funds. Depending upon circumstances, rationing devices included choosing those who had the best collateral, or who were the most politically well connected, or those willing to pay the largest bribe to banking officials.

These findings led to further research to substantiate the results and to develop new approaches to small-farmer credit. Much of the work was carried out by Ohio State University under contract to USAID. The Ohio State work led to development of a new approach to small-farmer lending, emphasizing 1) positive real interest rates, 2) emphasis on sound financial institutions, 3) attention to the nonfinancial costs of borrowing, and 4) attention to resource mobilization.

USAID adjusted its approach to small-farmer lending, and more broadly its activity in the financial sector, to reflect these lessons. Agency policy prohibited lending at negative real interest rates and encouraged development of sound financial institutions. These lessons were gradually introduced into USAID programs, though other donors were much slower in applying them.

As part of an effort to disseminate this understanding and to relate it to another area of finance, USAID in 1990 prepared a paper for dissemination to other donor members of the Development Assistance Committee of the Organization for Economic Cooperation and Development. That paper, *Development Finance Institutions: A Discussion of Donor Experience,* looked at the experience of USAID and other donors in establishing investment banks. Those banks, or development finance institutions (DFIs), had been seen as a means of increasing productive investment in productive business enterprises by providing long-term finance. Since commercial banks specialized in short-term credit, it was thought that long-term investment consequently was underfinanced. Consequently, donors, including USAID, promoted creation of new, usually government-owned institutions intended to use donor funding and domestic savings resources to lend for "developmentally oriented" investment.

As the OECD paper makes clear, donor experience with this modality was generally unsatisfactory. Most development finance institutions failed to play the developmental role envisioned for them, and few DFIs even became financially sustainable. Several factors were at work. First, repayment experience was often unsatisfactory, as projects financed by DFIs frequently failed. Second, interest rates charged by DFIs often were not inflation adjusted: when inflation rates rose, the institution quickly began to decapitalize. Third, many DFIs concentrated more on channeling donor resources than on mobilizing savings on their own. As donors became disenchanted with them, DFIs had no resources to lend.

A study by USAID's Center for Development Information and Evaluation (CDIE) of one narrow segment of the financial market—that for venture capital, equity investment in emerging companies—concluded that investment in this sector was a mirage for donors. It appeared to be a promising means for speeding the development process by encouraging the growth of dynamic new companies. In practice, past USAID projects in this area (and donor activity more generally) have yielded only inconsequential results.

The study attributes the failure of USAID projects to two main tendencies. First, the Agency asks implementers to produce results in too many dimensions (e.g., asking venture capitalists to look for promising companies in the agricultural sector in the poorest regions of a country that also employ many women). Second, the ponderous way in which USAID moves from concept to action, together with the constraints on profit-making by USAID implementers, makes Agency projects unattractive to people with the required venture capital expertise.

Finally, CDIE recently studied a particular mechanism for promoting private sector development: the enterprise fund. Enterprise funds are medium-term investment companies established in transition economies to invest U.S. government grant funds into private companies, with the expectation that such investments will produce both a set of strong private enterprises and a strengthened equities market in the countries where these firms operate. Several of the funds have had serious problems. It is still too early to judge the final outcome of the enterprise fund experiment, but the results so far suggest that both the profitability of the investments and the ability of the funds to find suitable investments are dependent on the overall economic policy regime and institutional environment in the country where the investments are being made. If those conditions are not favorable, an enterprise fund will face great difficulties.

Drawing Conclusions

A careful reading of the three previous sections of this chapter will indicate the tentative nature of much of our knowledge about financial markets and their contribution, actual and potential, to economic development and to reducing poverty. Economic researchers have been unable to make definitive statements about the size of the contribution of this sector to overall growth, or even to make strong statements about how the sector should be organized. The Asian financial crisis was a total surprise to virtually all observers. USAID has had to operate in a world where such uncertainties have been prevalent, making project choices on the basis of judgments that have had to be tentative.

The same uncertainty has to surround efforts to evaluate the success of USAID projects in financial market development. Failure is easier to judge than success. The degree of success will depend upon the viewer's perspective, which is embedded in historical context. The approaches taken by the Asian "tigers" to financial market development looked masterly until mid-1997. The Japanese approach to corporate finance drew on close long-term ties between banks and manufacturers. It looked much more promising than the U.S. approach, which depended more on equity finance subject to the vagaries of short-term performance—until the Japanese banking crisis exposed the weakness of close ties between lenders and borrowers. Today's wisdom about these issues may be exposed in another decade as an illusion. Such problems do not make the drawing of conclusions impossible, but they do render them tentative.

2 USAID Capital Market Development Activities in the Case Study Countries

ONE MEANS for avoiding crises like that experienced in Asia is through broadening of capital markets, so that businesses and governments are less dependent on short-term bank lending. Short-term loans expose the borrower to the risk that the loan will not be renewed. If some adverse piece of news causes lenders to call their loans, the borrower can face a financial crisis. Enterprises can reduce that risk by long-term borrowing, in countries where it is available, or by selling part ownership of the enterprise. The reduction in financial risk that access to long-term finance implies for the firm may lead it to make larger investments in projects with longer gestation periods, possibly leading to productivity growth over the long term.

A number of USAID projects in recent years have sought to promote longer term financial market development, primarily through establishment or strengthening of stock markets. This study examines a group of those projects. Its purpose is to examine the effectiveness of USAID assistance, to draw conclusions about the importance of such assistance for USAID sustainable development goals. Three basic issues are being studied:

1. Can USAID do capital markets projects well?

2. If so, do capital markets projects spur economic growth?

3. Who benefits from the growth produced by such projects?

During 1997–98, CDIE-led teams carried out fieldwork to review recent USAID-funded capital markets projects in India, Kenya, Morocco, Romania, and the Philippines. In addition, a CDIE researcher has written a case study of an earlier USAID capital market development effort: creation of investment banks in Central America in the 1960s.

USAID Projects Studied

1. *India.* USAID's principal activity to promote capital markets is the Financial Institutions Reform and Expansion (FIRE)

project. It was begun in fiscal year 1994, with $20 million plus $20 million in housing guaranty funds, and terminated by the Agency in 1998 following India's nuclear tests. FIRE activities included strengthening the government securities regulatory agency, improving stock market institutions including a screen-based securities trading system and a securities depository institution, and promoting improvements in the debt market. Two earlier projects also addressed aspects of capital market development. The Program for the Advancement of Commercial Technology helped spur the venture capital industry, and housing guaranty assistance to the Housing Development Finance Company promoted development of a mortgage market.

2. *Kenya*. USAID supported the development of capital markets in Kenya between 1988 and 1996. The object of this support was a newly created regulatory body, the Capital Markets Authority (CMA). The total level of support provided during that period was less than $1 million. The most significant component was long-term technical assistance to the Capital Markets Authority and to the Nairobi Stock Exchange. The adviser provided day-to-day guidance and technical expertise to the staff of the CMA. During his tenure, the CMA drafted and put into operation the regulatory framework that governs the market. He helped set up a public information center at the CMA and initiated public awareness seminars and courses. At the Nairobi Stock Exchange, the adviser prepared the trading floor operating procedures, trained exchange members in open-outcry trading, and helped the NSE establish its operating procedures.

USAID financed computer equipment and the installation of an NSE office and trading floor. Kenyan capital market experts participated in USAID-funded training and study tours between 1990 and 1995. Officials of the Capital Markets Authority received training at the U.S. Securities and Exchange Commission. Two groups of CMA officials and NSE members visited Southeast Asian markets. Others attended international conferences and annual meetings of securities market associations.

3. *Morocco.* The USAID mission in Morocco explored options to support the development of the capital market in 1991 by commissioning two studies. One examined the stock exchange; the other, establishment of a secondary debt market. After considering its options, the mission decided to undertake a large privatization support program rather than a capital or financial market support program. A subsidiary interest in capital markets was carried into the privatization support program.

The program was a $25 million effort. Of that amount, $20 million was nonproject assistance, and $5 million went to related technical assistance. The program document concluded that "to take full advantage of the opportunities presented by privatization, the weaknesses in Morocco's capital market will need to be addressed." Through conditionality, the program required a promotional and educational campaign on the benefits (and risks) of share ownership. It also required identification of possible measures to promote broader public share ownership and stipulated that 6 of the 28 privatizations in the program be done through the stock market. A long-term adviser, funded from another project, provided technical assistance on the interbank market, the money market, and the stock market.

4. *The Philippines.* In 1993, USAID began a five-year $13.5 million Capital Markets Development Project. Its goal was to strengthen the integrity and capacity of the capital markets to help increase the flow of equity and debt securities, to encourage savings mobilization and increase the quantity and quality of private investment. The project included both public and private sector components. The public sector component included assistance to the securities regulatory agency, the Securities and Exchange Commission, under the management of the Ministry of Finance. The private sector component included assistance to an umbrella association of private sector financial institutions, the Financial Executives Institute of the Philippines.

5. *Romania.* Although communism ended in 1989, by 1995 only limited moves toward economic liberalization had gone forward. Strict state controls gripped most markets, and state-owned enterprises dominated the economy. Investment had been misallocated, and the economy was using the wrong processes to produce the wrong commodities. The economy needed to be opened up to world prices; state-owned firms needed to be privatized and a market created to allocate capital to firms that could use it most effectively. An important move toward liberalization was the planned mass privatization of 5,600 medium-size and small state-owned firms—but there was no market to price shares or to allow people to buy and sell shares. If privatization was to succeed, a stock market had to be created.

USAID wanted to help the privatization effort and at the same time improve capital allocation—but none of the necessary institutions existed. Agency projects helped create a stock market (Rasdaq), a capital market regulator (a securities exchange commission), stock market laws and regulations, self-regulatory organizations, a stock brokerage community, mutual funds, and a stock registry, depository, and transfer agent.

6. *Central America.* A somewhat different type of study was carried out in Central America. In that region, USAID established a number of financial intermediar-

ies to promote long-term investment. These development financial institutions, or *financieras* as they were called in Latin America, were intended to make loans or equity investments in promising companies. By the 1970s, as described in the previous chapter, USAID had become disillusioned with these institutions and sharply reduced assistance to development finance institutions.

3 Program Performance And Outcomes

Program Outcomes

FOR EACH of the five projects reviewed for this study, the CDIE evaluation team prepared an impact assessment. Those studies, listed in the bibliography, provide detailed descriptions of the projects and their outcomes. Briefly, the findings are as follows:

1. *India.* The team found the project to be highly successful in strengthening the regulatory framework for the Indian securities market. Substantial amounts of technical assistance aided the Securities and Exchange Board of India to improve procedures and to move toward more effective regulation of the industry. This has made the Indian securities market more attractive for foreign and domestic investment.

2. *Kenya*. The evaluation team found the project to be successful, helping the Kenyan Capital Markets Authority and the Nairobi Stock Exchange to acquire the expertise to carry out their mandate. The very limited assistance provided by the project (under $1 million) was important because it came at the formative stage of the development of these institutions. Nevertheless, the evaluators found that the strengthening of the equities market had not contributed much to the financing of private business expansion in Kenya. Weak macroeconomic policy and an unwillingness of closely held firms to undertake the disclosure and other requirements for listing have limited the impact of the new institutions.

3. *Morocco.* This project was successful in raising activity on the Casablanca Stock Exchange and in broadening the investor base. As intended in the project design, it provided a tool for privatization of government enterprises. It also was able to provide a means for connecting savers with small and medium-size enterprises. The project was much less successful in inducing private Moroccan companies to become listed on the exchange.

4. *The Philippines.* The Philippines project successfully reoriented the Philippines Securities and Exchange Commission away from approval of individual issues to an American-style institution, enforcing disclosure on companies and

drawing upon self-regulatory organizations in the financial industry. A securities depository was also created. The reform of the Securities and Exchange Commission was seen as a great achievement by the Philippine financial community. Achievement of the reform required an announcement by USAID that it would terminate its project unless the government made personnel changes to permit reform. The ultimatum motivated the government to make the necessary changes. That was perhaps the most important action leading to project success.

5. *Romania.* The Romania project succeeded in creating a fully operating stock exchange in less than a year, creating competition for the existing stock exchange. This provided a market for issues of smaller companies, most of which had been privatized by the Romanian government. This was a clear technical success, but the value of the new exchange's market niche, and its impact on the Romanian economy over the long term, are uncertain. Shortcomings in government economic policies and the slow pace of privatizations were serious obstacles to a larger role. Project assistance to the government regulators was seen as valuable, but the evaluators concluded that the National Securities Commission still had significant problems, predominantly in its enforcement powers.

6. *Central America.* USAID's efforts in Central America during the 1960s were designed to promote long-term financing by establishing new institutions. This experiment largely failed. None of the institutions established in any of the Central

Table 1. Summary of Project Characteristics

Country	USAID Project Amount ($m)	Purpose	Direct Outcome	Financial Impact	Systematic Effects	Long-Term Sustainability
India	20	regulatory, institutions	successful	significant	considerable	probable
Kenya	1	basic TA	successful	small	significant	uncertain
Morocco	5	basic TA	successful	small	significant	uncertain
Phillippines	13	regulatory, institutions	successful	significant	considerable	probable
Romania	25	new stock market, regulatory	successful	small	uncertain	questionable

American countries maintained itself by following the original purpose for which USAID assisted in its creation. Some of the institutions failed and disappeared. Others adapted to the environment in which they were operating by shifting to short-term lending. That reduced their risk and allowed the institutions to balance their lending portfolio to the term structure (generally very short term) of the resources that they were able to attract.

In summary, all five of the recent projects were successfully completed. They produced the institutional result intended in the project design. Their higher level outcomes were more mixed. Table 1 summarizes some of the characteristics of the five case studies. The judgments there are tentative, since there is much uncertainty about what changes in actual activity can be traced to the projects, and some outcomes may begin to appear only slowly, and later in time than the examination of the projects. Nevertheless, the matrix suggests that country policies are important to project success and that the link between strengthening of the equity market and additional capital availability for firms is a tenuous one.

Rationale for USAID Assistance

That USAID stock market development projects have been implemented successfully does not itself provide a sufficient justification for Agency involvement in this sector. Nor does the conclusion that stock markets are an important instrument in reducing poverty over the long term (a topic discussed later) provide a sufficient justification. The fact that stock exchanges are instruments for financial gain by their participants creates an expectation that the private sector should be able to undertake any necessary and useful action in this field. Why should USAID become involved at all?

The basic answer seems to be that capital markets developed by the private sector alone will not produce the most satisfactory development result. Capital market development should not be left to market forces, because it will produce poor results. There are two areas where experience shows that regulation is needed to make possible the development of a vibrant equities market: protection of investors from firms; and protection of both investors and firms from stock market intermediaries.

Protection of Investors From Firms

Recent research (e.g., La Porta and others, 1999) has shown that legal protection of minority stockholders and of creditors from the managers and majority stockholders of firms is closely linked to the development of capital markets. Countries with such protections have larger and broader capital markets, wider ownership of shares, and more efficient allocation of capital among firms than countries without such protections. Another recent study (Johnson and Shleifer, 1999) contrasts the dramatic difference in development of equities markets in Poland and the Czech Republic. In Poland investors had legal protection and the stock market has grown rapidly. In the Czech Republic legal protections were missing and the stock market has not been able to mobilize capital for investment. The study provides a convincing rationale why such protections will not arise naturally by market forces.

Protection of Investors And Firms From Stock Market Intermediaries

Stock markets are established by neither the suppliers of capital nor the firms needing capital, but by intermediaries. From the point of view of suppliers and demanders, and from the public at large, the best intermediation process is one that is transparent and has low transactions costs. But observation of actual stock markets in countries without strong governmental regulation will show that this situation does not occur naturally. Instead, the market intermediaries are likely to create monopolistic arrangements that lead to high transactions costs, an atmosphere permissive of self-dealing and rigged transactions, and insufficient flow of information to potential investors. The market is made for the convenience of the market-makers. Only very slowly over time, under organized pressure from others, will the market-makers gradually begin to eliminate these obstacles to efficiency.

Moreover, stock exchanges are what economists call natural monopolies. One can conceive of multiple stock exchanges offering the same stocks (and the United States once had numerous regional exchanges), but this situation is unlikely to last. Both buyers and sellers are interested in good execution of their transaction—meaning a quick transaction at close to the price existing when the decision was made. The best execution is likely to be at the exchange that has the largest volume (i.e., the greatest liquidity) in the stock in question.

Any advantage that one exchange has in volume will thus lead to greater volume and to a greater advantage over its competitors. It ultimately ends up with all the business. In most countries, the stock market that emerges will be owned by its members, whose interest is in limiting competition among the membership and in commission rates that provide for comfortable incomes for members. (In the United States, it was only government action during the 1970s that forced the leading U.S. stock exchange to allow commission rates to be negotiated—leading to the lower commission rates that dramatically expanded market volume.)

In sum, it is only through strong government regulation and supervision of the financial markets that firms and market-makers can be forced to operate in a manner that serves the public interest efficiently. Efficient markets are a public good that require government intervention if they are to work well. USAID has shown that it is capable of transferring the necessary technology to developing-country governments, and therefore has a useful role to play in establishing this necessary set of institutions.

Performance Monitoring

Current USAID practice is to give emphasis to monitoring performance of ongoing activities during implementation. The Agency has shown a strong preference for activities to establish benchmarks and performance targets for each year of the implementation process. Decisions about whether to fully fund programs or to terminate them sometimes depend in part upon the performance in relation to targets. In the case of stock market projects, this approach has been shown to have dangers.

Stock markets would seem to be an ideal candidate for quantitative measures of performance. Such measures abound; they include the number of stocks listed, the market capitalization of listed stocks, indexes of stock prices, number of new issues, inflows to the stock market by foreign investors. Development planners concerned with performance monitoring can draw nice trend lines, showing an expected steady expansion of a country's stock market. Each year, the number of listed companies would rise in line with the country's growth, as emerging companies issue initial public offerings. The stock market capitalization would also increase, probably at a steady rate that is faster than gross national product growth, as prices of older companies rise and newer companies are added. Trading volume would also rise steadily, as more people began using the stock market and as the market became more liquid.

Unfortunately, this conceptualization does not describe the operation of real stock markets. All real markets seem to be characterized by periods of exuberance and periods of decline. Moreover, none of these variables is an unambiguous indicator of progress. Stock markets are notoriously volatile, and rising values can sometimes reflect speculative excesses, so that declines represent a return to proper pricing. The number of initial public offerings is subject to market conditions as well as regulatory factors. In India, USAID chose the number of initial public offerings as a performance benchmark under the assumption that this would rise as stock market oversight improved. But the opposite happened, as the government tightened listing requirements following a series of financial scandals. It began delisting companies that failed to provide adequate financial information to investors.

The basic conclusion in this area is that there is no easy way to monitor the progress of an ongoing capital markets project. The key judgments of progress seem to be qualitative rather than quantitative; they require people with substantial experience in this area to make them. USAID to date has not developed qualitative indicators for capital markets development. One of the conclusions of the Kenya/Morocco case study provides perhaps the best statement of the proper conclusion in this area:

> Missions undertaking capital market projects should be held accountable for the quality of the institutions they assist but not for the level of market activity. Stock and bond markets reflect the state of the national economy, which itself is the result of host government economic policies, the underlying structure of the economy, and external factors. Market indices will rise and fall during and after the USAID activity. The goal of a USAID activity should be to help put in place institutions capable of meeting the financial intermediation demands of the private sector.

Capital Markets And Poverty

One of the original goals of the study was to include some analysis of the distributional consequences—and particularly the impact on poverty—of the development of capital markets. That proved to be beyond the capacity of the evaluators, for the relationships involved are nuanced and complex. The evaluators could find no convincing empirical evidence regarding the impact of the development of equities markets on the distribution of income. Deductively, one can posit a variety of influences, some (e.g., the rise in wealth of holders of securities) tending to increase inequality and others (e.g., increased demand for skilled workers and increased access to financing by nonelites) that would tend to decrease it. How these various factors sum in practical cases, though, is conjectural.

On the issue of the impact of capital market development on poverty, the case for a positive relationship is much stronger, but still indirect and gradual. Of the country studies, only the India paper dealt with this issue in detail, and it did so in terms of broad concepts. Before dealing with those concepts, though, let us consider the results of an earlier study.

Batchelder and Holt (1997) have drawn upon the historical experience of developing countries regarding the relationship between economic growth and poverty to make projections for India and other countries of future poverty levels. They provide two scenarios for India, based on assumptions about economic policy. Under the "poor policy" scenario, where government restrictions prevent free markets from operating in capital markets and foreign trade, growth would average 1.2 percent per capita per year, while it would average 5 percent per capita under market-based policies.

The difference in poverty between the two scenarios is stark. With poor policies, the number of poor (those with per capita incomes below $1 a day) increases slightly, from 473 million to 476 million, though their share in the population falls from 51 percent to 37 percent. With the faster growth resulting from market-based policies, the number of poor falls from 473 million to 174 million, or from 51 percent of the population to 14 percent. (This decline is roughly in line with what occurred in Indonesia over the last 25 years.)

Batchelder and Holt's scenarios overstate the difference in India. Its policies have moved a substantial distance over the past five years toward free markets for goods and finance, and recent economic growth rates have reflected those better policies. Nevertheless, the basic point is shown by experience. Countries with better policies have substantially faster rates of poverty reduction. This model, of course, does not separate improvements in capital markets from other policy changes. Improvements in capital markets alone would be expected to provide some fraction of the impetus to growth found by Batchelder and Holt.

In broad terms, the work of USAID activities is intended to improve the efficiency of capital markets. Increased efficiency in the financial sector in turn is expected to direct financial resources into the sectors where their productivity is highest. This in turn is expected to increase the rate of economic growth in the country receiving the assistance. Faster economic growth in turn is expected to reduce poverty. The link between increases in income and reductions in poverty is empirically strongly established over the medium and long term. (For shorter periods of time, the two can move in opposite directions because of a variety of factors. But extreme poverty—the World Bank uses $1 a day per person—is common only in countries where average incomes are also low.) The following section uses capital markets in India as an example of the types of problems faced in many developing countries.

The Case of India

The empirical link between market-oriented polices and growth is important in the present context because the link between USAID capital markets projects and poverty reduction is neither direct nor immediate. At present, companies that raise capital because of improvements in the structure of the capital market will not make major increases in employment as a result. Nor will the Indian stock market provide a means for the great bulk of small and medium-size enterprises in India to gain capital for expansion.

Improvement in the structure of the equity market will directly affect perhaps several thousand companies, not the millions of smaller enterprises that constitute the mass of business enterprises. (Large firms do dominate output: in India, the 3,000 largest companies account for half of all manufacturing value added.) For their capital needs, small firms will, as elsewhere, need to rely primarily on internally generated savings, funds from family and associates, and borrowing from banks. Despite these limitations, work in capital markets appears, in the longer term, to be a critical element in the rapid reduction in poverty in India.

From independence, the Indian government has given central importance to investment and to capital. Successive governments have believed that capital was the key constraint in the Indian economy, so capital was seen as needing to be allocated carefully to avoid waste. The Indian governments used central planning as the vehicle to achieve this. Much investment would be directly by government enterprises in response to the planners' projections. Private companies would be prevented from overinvesting in capacity by a requirement that government permission would be necessary for any expansion of their factories.

In sum, the Indian planning model was centered on concern about using capital efficiently. In 1950, the theory had considerable plausibility. The West had recovered from a lengthy depression only through the onset of world war, and the Soviet Union appeared to have made a great leap forward into industrialization through central planning.

This theory had two central assumptions that proved fallacious in practice. It was assumed that efficient production resulted more or less automatically from modern technocratic management of industrial concerns. Getting maximum production from a set of machines was seen as a straightforward *engineering* problem. The critical problem for economic growth was to ensure that all factories had the proper amount of capital so that the entire productive structure could move forward together. Second, the types of goods to be produced were conceived of in simplistic terms—tons of steel, numbers of automobiles, pairs of shoes—implicitly assuming that each industry produced homogenous products for which the needs of the economy could be measured quantitatively.

The experience since 1950 demonstrates that modern economies are not like that. For the needs of steel-using industry, the problem is not simply the number of tons of steel produced, but the number of tons of steel of particular specifications available in a particular place at a particular time. Planning processes are powerless to deal effectively with the qualitative, location, and time dimensions. Only the flexibility of a market system, where the producer is rewarded for meeting these requirements by the prospect of profit, and punished for failing to do so by the prospect of loss (and bankruptcy), has proven capable of this. The problem of specifications is compounded with consumer goods. If all consumers preferred size 9 brown penny loafers, the problem of predicting and meeting consumer demand for shoes would be relatively straightforward. But consumer preferences both vary widely and change over time.

Another factor is technological advancement. Technology change in both manufacturing processes in the world and in design of consumer goods has been rapid. Consequently, the idea of a knowable and fixed capacity for production for each factory disappears. To remain efficient, managers in each factory have to continually revise their production methods, adding machinery and techniques in line with evolving technology. They need to change the product in line with changing designs and new materials. In sum, they must continually make new decisions about what to produce and how to produce it. Once the magnitude of these problems becomes clear, it becomes evident that central planning is simply not capable of meeting the needs of a modern economy.

The core of the process is what Joseph Schumpeter called "creative destruction," which is at the core of modern market economies. Companies and entire industries that do not maintain competitiveness in the long run by adapting new technologies are simply pushed aside. Enterprises go bankrupt, or are acquired by others, to reorganize people and capital equipment into arrangements that can produce efficiently what is wanted by society.

As we look around India, it is clear that much capital is wasted or misallocated. Because of the uncertainty of electric power, businesses have their own generators. Dozens of ships wait in the port of Bombay for their turn to offload or load. Bungalows for government offices and residences, relics of a quieter day, still sit in the shadow of Bombay skyscrapers on some of the most valuable land in India. More broadly, the amount of economic growth that has occurred in India is not commensurate with the amount of capital investment that has been taking place. To achieve faster economic growth, and faster reduction in poverty, capital needs to be used more efficiently.

This continuous revaluation of capital assets provides three important functions. First, it signals to other providers of capital, such as banks, the prospects, and therefore the riskiness, of lending to companies. Second, it provides incentives for new firms to enter promising sectors, and for investors to seek out and invest in companies of the future. Third, it provides the means, through takeovers of existing companies by more efficient firms, to redeploy the capital in a more efficient way. In the longer term, restructuring of the capital base and the means by which capital can be drawn to the most efficient use provides the most promising way for productivity of labor to be increased. Increasing labor productivity is the only sure means for steadily increasing wage rates and incomes.

4 Lessons Learned

FROM THE SIX COUNTRY CASE STUDIES, a number of lessons can be drawn. They are as follows:

1. USAID ***should continue to support development of capital market institutions.*** All the recent projects studied had a considerable degree of success. They strongly support the view that USAID can do this type of project well. The evidence that there is a high developmental payoff to this kind of activity is much more tenuous, for capital markets are institutions whose importance cannot easily be measured—but the evidence suggests that it may be quite high.

2. USAID ***activities should emphasize the regulatory framework and avoid direct financing of investment capital.*** A good legal and regulatory framework and strong government oversight are needed to make capital markets work efficiently. The primary emphasis of USAID support should be on technical assistance and training for this rather than financing of hardware for the operation of the market itself. Nevertheless, some support of the latter may be useful in supporting goals in the regulatory area, as in the Philippines case.

3. USAID ***assistance should promote the general approach used in the U.S. capital market.*** This approach—including a strong governmental regulatory body—has shown itself to be appropriate for developing countries. The emphasis in this approach on disclosure of relevant circumstances rather than government approval of individual issues provides more flexibility and greater opportunity for new activities than models based on government approval of individual issues of capital stock. The projects reviewed show that USAID can identify and contract appropriate expertise to transfer the U.S. technology.

4. USAID ***should undertake projects in this area only where the economic climate is favorable.*** A stock market is an institution that promotes faster economic growth in a favorable environment, but is unlikely to be an important catalyst for the adoption of better economic policies. Successful government efforts to privatize state-owned enterprises can support stock market development.

5. USAID should be skeptical of regional approaches to stock market development. Stock markets are subject to economies of scale, so promotion of their development is easiest in large countries. In regions where USAID works that are composed mainly of small countries (e.g., Central America or various parts of Africa), efforts to promote a set of officially promoted regional structures are likely to arise. The literature indicates that such approaches are unlikely to work, and should be resisted. The free flow of finance among a group of countries will tend to lead to one of the region's stock markets becoming dominant. Transactions will flow to the most liquid market, which will have the lowest transaction costs. Such an outcome may be desirable from the region's perspective, but it is likely to be resisted by the individual governments in the region, for whom a national stock market now has the appeal that a national airline once had.

6. USAID should look for ways to promote development of debt markets. The literature demonstrates that in the longer term, creation of long-term debt markets is essential to reduce the risk of financial crises, such as the recent Asian experience. This will require improvements in government policy to eliminate inflationary expectations and reduce crowding out by government. Throughout the developing world, substantial progress has been made on these issues during the past few years, so the prospects for persuading savers to acquire long-term securities is much better than it has been in the past. Long-term finance for infrastructure has great potential for promotion of growth, and innovations in debt markets can support this objective.

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