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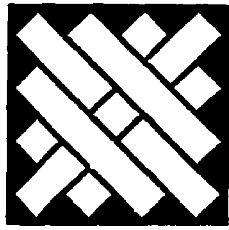

DEVELOPMENT COMMITTEE

NUMBER THIRTY-ONE

Development Issues

Presentations to the 46th Meeting of the Development Committee

Washington, D.C.—May 1, 1993

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Joint Ministerial Committee of
the Boards of Governors of
the World Bank and the International Monetary Fund
on the
Transfer of Real Resources to Developing Countries
(Development Committee)
Washington, D.C.

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Established in October 1974, the Development Committee is known formally as the Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries. The Committee's members, usually Ministers of Finance, are appointed in turn for successive periods of two years by one of the countries or groups of countries represented on the Bank's or the Fund's Board of Executive Directors. The Committee is required to advise and report to the Boards of Governors of the Bank and the Fund on all aspects of the broad questions of the transfer of real resources to developing countries, and to make suggestions for consideration by those concerned regarding the implementation of its conclusions.

The International Bank for Reconstruction and Development (IBRD) and its affiliate, the International Development Association (IDA), together constitute the World Bank. The International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) are other affiliates of the IBRD.

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FOREWORD

The Development Committee held its 46th meeting in Washington, D.C., on May 1, 1993. This was one of a series of meetings about the interactions between the policies of industrial and developing countries. It was also a follow-up to the discussion of resource flows and transfers to the developing countries at the Committee's meeting in September 1992.

Ministers devoted most of their time to reviewing the prospects for increasing flows of private resources and improving the access of developing countries to the world markets for loan and equity capital. They also focussed on the role of the World Bank and the International Monetary Fund in promoting and catalyzing private flows, and the extent of any remaining obstacles placed by Member countries in the way of private flows.

The Committee based its discussion on the joint paper by the World Bank and the IMF, and on a series of supplementary papers provided by Members of the Committee, other international organizations, and independent experts.

Ministers also discussed a progress report presented to the Committee on the implementation of the World Bank's strategy for the Private Sector Development.

Ministers took note of the progress made on several issues, such as international trade (including Uruguay Round negotiations), debt strategy and environment protection which were outlined in the report of the President of the World Bank.

In view of the broad interest in these subjects, the presentation made to this meeting of the Committee are made available (in three languages--English, French and Spanish) for a wider audience.

Peter Mountfield
Executive Secretary
May 1993

PAPER BY THE CHAIRMAN OF THE DEVELOPMENT COMMITTEE
RICARDO HAUSMANN, MINISTER OF STATE AND HEAD OF CORDIPLAN
VENEZUELA

Introduction

The main theme for our meeting is "Developing Country Access to Private Capital Flows". It is one of our regular reviews of the interactions between the policies of industrial and developing countries; and it follows naturally from our discussion in September 1992 of "The Transfer of Resources to Developing Countries". A subsidiary but related theme is the Progress Report on the World Bank Group's Private Sector Development Strategy; I think this is a valuable paper and does not require further comment from me.

Papers

The main paper before us is the Issues Paper prepared by the World Bank and the IMF "Developing Country Access to Private Capital Flows" (DC/93-4). This contains both a valuable analysis and a number of practical proposals for further action by the three main groups of players: the industrial or "source" countries; the developing or "host" countries; and the international financial organizations. I suggest that we follow this framework in addressing the problems.

Further valuable analysis is contained in two recent reports to be issued by the Bank and the Fund. The first of these, to be published on April 19 but already available to Executive Directors, is the Bank's "Global Economic Prospects", which this year concentrates on "External Finance in the Nineties". The second is the latest in the IMF's series of annual reviews of global capital markets to be published in May; advance copies will be available for Fund EDs in late April.

In addition, I have (as the Committee agreed) invited supplementary papers both from Members of the Committee and from independent experts. The Executive Secretary has already, at my request, circulated a list of these papers (DC/93-3). This list also includes a classified index of the main suggestions made in the papers, including those of the staff, and each suggestion has been given an individual number so as to simplify reference during the meeting. Taken together, these papers will provide an impressive mass of material to stimulate our discussions.

Issues

As I see it, the question before us is this. For "the first tier" of developing countries, who have either never lost access to financial markets, or have recently regained it, the prospects are good, provided they can maintain their credit through the pursuit of sensible macroeconomic policies. We shall want to discuss how this can best be done.

Then there is a "second tier" of countries, mainly in the middle-income bracket, who are now within sight of breaking into the markets; for them, the question is what actions are needed, either by their own governments, by those of the "source" countries, or by the IFIs, which might help to accelerate the process. I believe strongly that the market mechanism will solve most of the problems of market access, once a "host" country has the right policies in place, provided that the industrial countries play their part. But as these papers make clear, there are several obstacles in the way. Many of them are the result of imperfect information, or undeveloped institutions. We must consider whether any of these frictional impediments to market finance can be removed through action by one or other of the parties involved.

For the "third tier", consisting mainly of the countries in the "IDA-eligible" category, the problem is different: few of them are in a position to seek much private money, save for certain types of Foreign Direct Investment. We must certainly ask ourselves whether anything more can be done to help these countries attract private investment. But it seems inevitable that, for the next few years, their main external source of funds will be Official Development Assistance. We must return to the question of ODA at future meetings.

After reviewing all the suggestions made in both the staff and the supplementary papers, it seems to me that the most useful areas for us to discuss are these:

(a) Taxation It seems clear that investors are less worried by the level of taxation on their profits than by uncertainty about future tax liabilities. Professor Stiglitz proposes a voluntary cap on tax rates, reinforced by Bank and Fund conditionality. Some bilateral tax treaties (double taxation agreements) incorporate such limits on profit taxes. Others give investors a degree of comfort by promising "national treatment" which provides protection against unfair discrimination. One major area of uncertainty concerns the treatment of capital gains once an investor decides to liquidate his investment and move on; he does not always receive credit in his "home" country for tax paid on capital gains in the "host" government. All this suggests that both groups of governments need to review their tax codes, with the object of removing obstacles to investment in developing countries. The Bank and the Fund already provide valuable technical assistance to developing countries in this area. The Committee might consider inviting them to develop "guidelines" for double taxation agreements, on the lines of the "Investment Guidelines" prepared by the Bank for our last meeting. In particular, they might review existing model agreements, such as that produced by OECD, to see what modifications (if any) might be recommended to meet the special circumstances of developing countries.

(b) It is clear that the institutional investor market (specially in North America and Europe) has not so far been a big source of funds for the developing countries. Mr. Qureshi reminds us of the scale of the funds at their disposal; a very small change would greatly increase the pool of resources

potentially available for profitable investment in developing countries. I very much agree that existing regulatory systems sometimes place unnecessary barriers in the way of such investment. This regulation can even be short-sighted if it deprives the beneficiaries (insurance policy holders and pensioners) of good investment opportunities; in any case many of the remaining risks could be offset by suitable hedging. I suggest we invite industrial country governments to look again at their regulatory regimes with a view to permitting more investment in emerging markets.

Such investment would also be helped by making it easier to obtain market ratings for investment in developing countries. Without an "investment-grade" rating by agencies like S&P or Moodys, most institutional investors will be reluctant to invest, even if the regulatory regime is relaxed. There are at least two ways of helping. One (which has been discussed in Latin America several times) is the creation of regional rating agencies. This would compensate for the apparent reluctance of the existing agencies to incur the high start-up costs of extending their operations to countries with small domestic markets. It would also help to reduce the high cost to the borrower of obtaining a rating from agencies not currently working in his country. However, a new agency, specially if established in the public sector, might not easily or quickly command the confidence of the markets. Mr. Bock suggests an alternative approach, working through the existing agencies, and using technical assistance from the World Bank to help developing countries design and present individual investment projects within a friendly institutional and legal framework which the agencies can readily understand, and thus to evaluate individual projects. He proposes establishing a special unit within the Bank to work closely with the rating agencies in this field. He switches the emphasis away from "country risk" towards "project risk". Both options deserve study. Members may have other proposals in this area. I suggest we ask the World Bank to review these various "rating" ideas and report to us again at a future meeting.

(c) The concept of risk insurance appears many times in the papers, with references to national export-credit and investment-insurance schemes and to MIGA. Professor Stiglitz proposes new multilateral schemes to insure against the terms-of-trade risks common to many developing countries, and also against fluctuating exchange rates. (I return to his ideas about hedging lower down.) I suggest that there are two main categories of risk which may not be fully covered by existing schemes at present: I would label them "policy risk" and "project risk".

A typical example of policy risk arises where a monopoly utility is privatized, but remains subject to regulation (for example, of its tariff structure) which may affect its future profitability. Clearly this can present a disincentive to a potential investor. (And as SELA reminds us, the purchaser of a privatized utility is an important source of subsequent new investment.) The host government can offer unilateral "policy guarantees" about the extent to which it will intervene in such cases. Is it possible to envisage any form of multilateral insurance, analogous to MIGA,

which could cover the risk that governments might not honor these policy guarantees?

The second category of risk is that the project will not be as profitable as its sponsors hope. A system of investment rating, coupled perhaps with the partial guarantees which Mr. Bock advocates, will deal with this category of risk as far as loan capital is concerned. Equity capital is the cushion which must absorb any losses. Considerations of moral hazard mean that the equity shareholder cannot and must not be protected against all risks. But it may be possible to mitigate some categories of risk, at least in the early stages of a new venture. Some "source" governments already provide investment guarantees, but I understand these normally cover only "transfer" and "political" risks; this is also true of MIGA. Is there a case for any limited bilateral or multilateral guarantee which would increase the flow of risk capital into developing countries? If "source" governments are able to accept a longer risk horizon than private investors, would they be prepared to offer a limited "repurchase" or "takeout" facility in cases where the private investor wishes to withdraw after (say) five years? Should we ask the World Bank Group to study these possibilities for us?

(d) Many types of risk can now be covered by hedging instruments. The World Bank draws attention to this in the Issues Paper, and already provides technical assistance in this area. At first sight this may not seem directly relevant to the potential foreign investor, who is more concerned with "project risk" as I have described it above, than with "systemic risk". But he is exposed to two kinds of systemic risk: those inherent in the project (for example, the impact of a global recession on its export earnings) and those which affect the host country's economic prosperity and thus the fiscal and regulatory environment within which he must operate. The investor can hedge himself against the first kind of risk in increasingly sophisticated commodities markets. The host government can similarly secure itself against many global risks (even the interest rate risks which Professor Stiglitz mentions can often be covered by interest swaps); and one by-product of its doing so is to provide a better climate for the foreign investor. Developing country governments may wish to study the extent to which they can further protect themselves in this way. I think the Committee should return to the whole question of Commodity Prices at a future meeting.

(e) Mr. Bock and others develop various proposals about mutual funds. The IFC did much pioneering work in developing and marketing the concept of "Country Funds", often providing a share of the initial capital. The advantage of such risk-spreading devices is obvious, and the market for "Country Funds" of the original pattern is now fairly mature, to the point where the IFC can begin to withdraw. But is there a case for a "second generation"? Professor Stiglitz proposes mutual funds operating at regional rather than country level, and drawing on the complementary expertise of a wider range of fund managers. Do "source country" members consider that this idea would be attractive to their investors? Can the Bank help in other ways than

through the provision of technical assistance and occasional seed-corn capital? For example, could it provide information about individual projects and sectors (with the agreement of host governments, of course) which would allow specialist funds to develop, specializing in "blue chip" projects endorsed in some way by the Bank? Such endorsement would not amount to a guarantee. It might be limited to projects in which the Bank was already a lender (an informal sort of cofinancing); or it might (as Mr. Qureshi suggests) take the form of identifying key sectors like infrastructure and environment protection, consistent with the agreed country development strategy and thus likely to prove of high priority to the "host" government.

(f) Guaranteed Export Credit has historically been an important source of development finance. As Mr. Stephens points out, several "source country" agencies burnt their fingers badly in the early 1980s. We cannot blame them for seeking now to price their insurance facilities at more realistic levels which take account of perceived risk. (I don't think any of them are seeking to recover past losses in this way.) However, Mr. Stephens lists some very useful small-scale adjustments which the ECAs could make, individually or in the case of the OECD Consensus, collectively, to increase the flow of funds. May I ask industrial country Members (and their constituents) to take these ideas away and consider them carefully; I should like to review action taken on them at a future meeting. Mr. Stephens also draws attention to the Bank's "negative pledge clause" which has just been reviewed by the Executive Board. Perhaps the Bank would explain the decision to us at the meeting.

Conclusion

I hope that our discussion of these themes and of other points which Members may make during the meeting, will not end with the issue of our Communique at the end of the meeting. I am anxious that the various players should follow up the discussion, and I have indicated above some of the points which might be considered in greater detail after the meeting. I plan to leave sufficient time at our meeting in September to review the results of these further reflections.

REPORT BY LEWIS T. PRESTON
PRESIDENT OF THE WORLD BANK

I. Introduction

1. At its September 1992 meeting, the Development Committee assessed the overall volume of capital flows to developing countries and discussed a wide range of issues regarding their provision and use. This meeting focuses on an increasingly important aspect of that top.. -- developing-country access to private capital flows. Staffs of the World Bank and International Monetary Fund have prepared an issues paper for the Committee that surveys the recent dramatic increase in private flows; assesses policies in source and host countries that might further stimulate such flows; and discusses the role of international financial institutions in this area. In addition, the Committee will have before it a progress report on the implementation of the World Bank Group's plan of action for private sector development in developing countries.

2. This President's Report places private capital flows in the context of the current global economic environment and the priority development objectives of the developing countries. The report also touches on some current issues relating to the Bank Group.

II. Current International Challenges and The Global Economy: Implications for Developing Countries

3. While many developing countries continue to make remarkable progress in both economic and social fields, there remain a number of major development challenges. Severe drought still plagues many countries in Southern and Eastern Africa, exacerbating poverty and imperiling millions of people. Civil and ethnic strife and political instability continue to undermine development efforts in several countries. The new nations of the former Soviet Union are experiencing extremely difficult problems as they undertake the historic transformation to market-oriented economies. The events in the former Yugoslavia are exacting a heavy human toll and wreaking economic havoc. The substantial reconstruction needs of the Middle East will need to be addressed as that region makes progress on the difficult path to peace. Many countries in Latin America have made great strides in adjusting their economies to function in a competitive market-oriented global system. These efforts need to continue to ensure the sustainability of the new framework, and increased attention must now be given to improving social services and addressing the problems of urban and rural poverty. Despite recent improvements in the policy framework and improving economic performance, poverty remains a major challenge in South Asia. In East Asia

and the Pacific, the incidence of absolute poverty has declined to 11 percent of the population, reflecting rapid economic growth and progress in human resource development. But a number of countries in this region face severe fiscal constraints, rising concerns about environmental issues, and complex transitions from centrally-planned to market economies. At the global level, the growing problems associated with the environment, increasing migration and refugees, the narcotics trade, and the scourge of AIDS add to the roster of challenges. In short, the development agenda is more than full.

A. Global Economic Prospects and Developing Countries

4. The ability of developing countries to tackle this full range of contemporary development problems will be greatly enhanced if economic growth for low- and middle-income countries over the next decade (1992-2002) accelerates, as projected in a recent World Bank staff report[1/], to 4.7 percent per annum. This would be a considerable improvement over the 2.7 percent attained over the past decade (1982-1992), based on a substantial turnaround in economic performance in Latin America, and, to a lesser extent, in Sub-Saharan Africa and the Middle East. It also assumes continued strong growth in East Asia and a consolidation of the recent improved performance in South Asia. The economies of Eastern Europe and of the nations of the former Soviet Union, however, have experienced major declines in output, and there remains great uncertainty on the timing and pace of their recovery.

5. This projected acceleration in overall growth is to a great extent predicated on the substantial improvement taking place in the policy environment in many developing countries with resultant higher domestic savings efforts, and the increased productivity of capital and labor.

6. Higher growth is also predicated on a substantially improved international environment in the 1990s. Such a favorable outcome is, of course, subject to uncertainty. First, the baseline projection assumes that the present economic recovery in the United States spreads to Europe and Japan over the next twelve

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1/ *See "Global Economic Prospects and the Developing Countries, 1993," Report No. SecM93-207. World Bank, February 1993.*

months. Second, the projection assumes a stabilization of real commodity prices, which have been declining for the past two decades. If prices continue to decline, growth in Sub-Saharan Africa and Latin America would be adversely affected. Third, rapid growth in middle-income countries is based in part on the remarkable resurgence of private capital flows in recent years. But the sustainability of these flows is heavily dependent on the continued pursuit of sound macroeconomic policies and a buoyant investment climate.

B. International Trade and the Uruguay Round

7. Finally, and most importantly, assumptions concerning the projected growth of world trade may turn out to be overly optimistic. In this context, previous President's Reports to the Development Committee have stressed the urgent necessity of reaching a prompt and successful conclusion to the Uruguay Round of multilateral trade negotiations. Unfortunately, however, there has been scant progress since the Committee's last meeting in September 1992. To the contrary: the increasing number of pleas for issues previously thought settled to be renegotiated under the Round is evidence of backsliding. Despite urgings from many quarters, important negotiation deadlines have passed unheeded in recent months, increasing the risk of the long-term postponement of the Round.

8. We should not assume that an alternative to an early multilateral agreement is a continuation of the status quo. In the current context of recession and slow recovery in most OECD countries, there is already a strong tendency for protectionist pressures to increase and for a vicious circle to ensue in which heightened protectionism only serves to impede recovery from recession. Moreover, unilateral measures to manage trade and a growing desire to protect domestic jobs in the industrial countries would distort resource allocations and deny efficient producers in developing countries the opportunity to exploit their comparative advantage.

9. Failure to reach a successful conclusion to the Uruguay Round this year would, therefore, have severe adverse negative consequences for the global economy, and particularly for developing countries, in the form of slower growth of world trade in relation to GDP growth and the possible weakening in the efforts of developing countries to liberalize their trade

policies. Given the current fragile world situation, such an economic shock would have significant political and social implications, and it would be naive to assume that the industrial countries can be insulated from a deterioration in the political and social situation in the developing world. This is a time for farsighted leadership and I would urge Ministers to treat this matter as one of extreme urgency, and to lend the considerable influence you enjoy in your capitals to ensure that the Uruguay Round is steered to a prompt and successful conclusion.

C. Progress on Debt Reduction

10. The debt crisis that began over a decade ago is largely over for commercial banks, and developing-country debt no longer poses a systemic threat to the international banking system. The crisis is also over for several middle-income borrowers, assisted by debt-restructuring operations and lower interest rates, though these countries remain vulnerable to adverse developments in their external economic environment. External viability remains elusive, however, for many low- and lower-middle-income countries. The difficulties associated with transition from a centrally-planned economy, including a reorientation of trade arrangements, also have included major debt problems in the nations of the former Soviet Union and some East European countries.

11. A number of recent developments related to debt reduction merit attention. Particularly noteworthy is the recent (late December 1992) agreement between Argentina and its commercial banks, supported by World Bank loan commitments of $750 million, which will help achieve commercial debt reduction of about $11 billion, or 37 percent of the face value of the eligible principal debt and past due interest to the commercial banks. In another significant development, the Philippines and its commercial-bank creditors reached agreement in early December 1992 on the second phase of the commercial-bank part of its overall external debt-reduction strategy. About $4.4 billion was eliminated or converted. As the largest economy in Latin America, we follow with interest the progress of Brazil's agreement with commercial bank creditors. By March 15, 1993, creditors representing 97 percent of Brazil's outstanding commercial bank debt had decided to participate in its debt-rescheduling program. Agreement on the financial instruments, and on the required enhancement, is necessary for closing the deal.

12. In this context, I am pleased to note that the Bank strategy dealing with countries with protracted arrears has been successfully implemented in the case of Peru. Three adjustment loans totaling $1.15 billion were signed in December. Some $900 million were disbursed in March under these loans, after the Government cleared its arrears with the Bank. The Bank has now resumed its normal lending relationship with Peru.

13. Steady progress has also occurred under Paris Club auspices with regard to a number of low-income countries. Since the Committee last met, seven additional agreements involving "enhanced Toronto terms" have been concluded -- with Ethiopia, Guinea, Honduras, Mali, Mauritania, Mozambique and Sierra Leone.

14. The IDA Debt Reduction Facility[2/] has recently seen a sharp increase in operations which have been cofinanced with a number of bilateral donors. Four operations totaling about $35 million have been completed (Guyana, Mozambique, Niger and Uganda). At an average cost of US$0.12 per dollar of debt, these operations have extinguished 89 percent of the commercial debt of these countries. The Board has recently approved an operation in Bolivia for $10 million and one for Nicaragua (for some $25 million) is under negotiation. A further five operations, all in Sub-Saharan Africa, are in the preparatory stage. I, therefore, plan to recommend to our Executive Directors that we replenish this facility when we allocate our net income at the end of the fiscal year to enable it to continue its debt-reduction assistance to eligible countries.

15. A portion of IDA reflows has been used under the "fifth dimension" program to provide supplementary adjustment credits to countries that are currently IDA-only borrowers and that have outstanding IBRD debt. Through annual allocations (in proportion to interest payments due to the IBRD), the supplementary IDA credits have helped ease the debt-service burden of eligible IDA-only borrowers undertaking adjustment programs. Between FY89 and FY92, some SDR 400 million were allocated for this purpose. For the current fiscal year the Board has approved supplementary IDA

[2/] *The Facility was established in FY90 with a grant of $100 million from the Bank's net income to support operations to buy back or otherwise substantially reduce or eliminate the commercial-bank debt of severely-indebted IDA-only countries which are adjusting and have comprehensive plans to deal with their debt problems.*

credits totaling SDR 121 million, or 70 percent of interest payments due to IBRD from the beneficiary countries. In addition, a number of bilateral donors provide parallel financing in support of the fifth dimension program.

16. These are all welcome developments. But additional measures will be necessary for many low- and lower-middle-income countries if they are to reduce significantly their currently unsustainable debt burdens, and more far-reaching debt-reduction arrangements are likely to be required for the most intractable cases among the low-income group. In this respect, I would strongly encourage all official creditors who have not already done so to -- at the very least -- urgently adopt the concessional options under the enhanced Toronto terms.

D. Capital Flows to Developing Countries

17. The third major external factor affecting the development prospects of developing
countries is the adequacy of external capital flows. This Report concentrates on some issues regarding official flows as a supplement to the Committee's primary concern at this meeting, which is developing-country access to private capital flows.

18. Private flows are crucial to the development efforts of middle-income countries and are of growing importance in a number of low-income countries as well. As discussed in the issues paper, there has been a tremendous increase in flows of private capital of all kinds to developing countries in recent years. Foreign direct investment flows to developing countries reached an estimated $37 billion in 1992, some 75 percent above the level of 1990. Private portfolio flows, which averaged under $6 billion a year in the period between 1982-88, were estimated at $34 billion in 1992. The composition of private flows has changed markedly in recent years -- from debt to equity financing and from bank to non-bank sources. Non-bank sources have accounted for virtually all the recent growth in financial flows to developing countries.

19. These highly welcome developments have benefitted countries which are creditworthy. Some 10 countries received over 70 percent of foreign direct investment flows in 1991, and the increase in private portfolio flows is highly concentrated in a few countries in Latin America and East Asia. The numerous middle- and lower-middle-income countries which continue to have

limited creditworthiness will find their access to private external finance dependent on continued progress with policy and institutional reforms and the adequacy of their economic and social infrastructure. Since these countries have limited access to concessional funds, their demand for external capital must be met in large part from official nonconcessional sources.

20. The outlook for concessional resource flows, which are vital to the development prospects of low-income countries, remains worrisome. Simply put, the situation is one of constrained supply and increased demand. The constraints on supply emanate from budgetary stringencies in a number of key donors and, in some cases, weakening support for aid on the part of publics and parliaments. The increased demand stems from both new challenges which require concessional assistance to low-income countries, including expanded efforts to protect the environment, and the several "new claimants" on concessional resources.

21. Despite this increased demand for ODA, many bilateral donors have cut back their aid programs in response to budgetary pressures, causing a further shortfall from the target of ODA flows of 0.7 percent of GNP re-endorsed at the United Nations Conference on Environment and Development (UNCED). This is a most unfortunate development, and one I would urge Ministers to try to reverse at their earliest opportunity. It is important to recognize that a failure to impart impetus to the development process could well result in far larger claims on resources in the long run by way of refugee relief, pressures for migration, humanitarian aid, and peace-keeping efforts. Within tighter aid budgets, it becomes even more important to improve aid effectiveness through well-designed programs, through a greater focus on low-income countries in aid programs, and through the untying of aid.

III. The Role of the Bank and IDA

22. Let me now turn to some issues that dominate the Bank's agenda as it attempts to
respond to these many challenges:

A. Countries in Transition in the Former Soviet Union and Eastern and Central Europe and the World Bank's Role

23. My last report to the Committee for its September 1992 meeting pointed to the many risks ahead for the countries of the former Soviet Union and Eastern and Central Europe. Some of these risks are materializing. Countries with a historical tradition of markets and legal institutions -- Hungary, Poland, and the Czech and Slovak Republics -- have been able to cope better, while others are finding it difficult to develop a political consensus around the policies and programs needed to manage the transition to market economies. Recorded output continued to fall in 1992. In the nations of the former Soviet Union output fell by 20 percent in 1992. In Eastern Europe, the rate of decline has slowed down, with output falling by 6 percent. These averages mask significant variations, with countries experiencing military conflicts and civil unrest seeing sharper output declines (Armenia and Tajikistan). On the other hand, Poland is showing signs of recovery and growth. On the stabilization front, inflation has accelerated in the ruble zone and in the Ukraine, while it has been substantially reduced in Hungary, Poland, and the ex-Czechoslovakia.

24. The output decline in part reflects the disruption in supply links of enterprises consequent upon the end of central planning and the sharp reduction in inter-republic trade based on state orders. An additional factor was the severe terms-of-trade shock facing oil- importing countries in Eastern Europe and the former Soviet Union -- as trade in oil began to take place at prices closer to world market prices. Inter-republic trade was also disrupted by the breakdown of payment clearance mechanisms. A further cause of output decline was the rapid shift in demand away from heavy industrial and military goods which account for a large share of the industrial base.

25. There are some encouraging signs, however, particularly at the microeconomic and local level. Over 30,000 small enterprises have already been privatized in the Russian Federation, and today at least 10 percent of the labor force is employed in the emerging private sector. Enterprises are working with local governments to redefine responsibilities in the provision of social services and public utilities. In Hungary, the number of registered private companies rose more than fourfold since 1989 to 66,000. The private sector is also showing rapid growth in

the Baltics, Bulgaria, Croatia, Czechoslovakia, Poland, and Romania. To such recent developments should be added the long-standing natural advantages possessed by the new nations -- they are rich in human capital, technology, and natural resources.

26. Over the past year, the Bank has geared up to face these challenges through additions to regional staff, including the establishment of new resident missions. A broad agenda for reform and Bank assistance has been developed in concert with the Bank's new members from the region and in close coordination with the IMF. It includes support to rationalize public finances; encourage price liberalization and competition policy; further privatization, financial sector reform and enterprise governance; augment human resources, social protection, and safety nets; create and rehabilitate infrastructure; expand the role of local governments; and improve the environment. A major challenge for the Bank is to design its interventions so that they support viable reform efforts in key areas and encourage far-sighted decision-making. Given the breadth of this reform agenda and the severity of institutional constraints, close coordination with other agencies and bilateral donors in meeting the region's massive technical assistance requirements is another sizeable challenge.

27. The Bank is deploying its resources so as to maintain maximum flexibility. Project preparation, as well as economic and sector work, is designed to promote reform and to mobilize resources rapidly in support of reform efforts. For instance, in Poland we are accelerating preparation of adjustment operations in the areas of agriculture and financial sector and enterprise reform. Financial sector adjustment operations are also under preparation in Romania and Bulgaria and activities simultaneously addressing enterprise and financial sector issues are underway in the Russian Federation, Kyrghyzstan, Kazakhstan and in the Baltic countries. An important lending program has been initiated in Eastern Europe to support the system of social assistance and a special "policy hub" has been established in Budapest to focus on social safety net issues across countries. The Bank is preparing large technical assistance loans for the Russian Federation, including the financial sector, social sectors and agricultural infrastructure, which could be expanded to possible adjustment operations in these sectors if enough progress is made in the overall adjustment program.

28. The process of transition in the nations of the former Soviet Union and Eastern and Central Europe is of truly historic significance. While the primary responsibility for this process rests with the governments and peoples of these new nations, external support --in the form of economic assistance and access to markets remains crucial -- not only for the successful transition to market-oriented economies in the new nations themselves, but also for a thriving and integrated global economy.

B. **IDA Lending and the Tenth Replenishment of its Resources**

29. Negotiations on the Tenth Replenishment of IDA's resources commenced in January 1992, and recent President's Reports have brought the Committee up to date on their progress. The final meeting of the IDA Deputies took place in Berne, Switzerland on December 14-15, 1992.

30. The negotiations were difficult and provided many insights into the issues confronting concessional assistance. Two important factors affecting the outcome of the negotiations were the difficult budgetary constraints facing many donor countries and the existing burden-sharing arrangements, which build in a funding shortfall. This last issue in particular will need to be addressed before the start of negotiations for the next replenishment of IDA.

31. For the moment, however, I am pleased to report that 34 donor countries have reached agreement on an IDA-10 replenishment totaling SDR 13 billion (approximately US$18 billion). This is an amount about equal to the volume of IDA-9 in real terms. Together with currently projected reflows, IDA's total commitment authority during the FY94-96 period will be about SDR 16 billion, or about US$22 billion. This lending could be augmented further by transfers from IBRD annual net income, if circumstances permit. In the face of severe budgetary pressures in many donor countries and numerous conflicting domestic and international demands on scarce concessional resources, the agreement on IDA-10 is a significant achievement in international cooperation for development. It is now necessary, however, to move forward with timely ratification of the agreement so that there will be no lapse in IDA's commitment authority. Necessary parliamentary and other measures should be taken expeditiously to bring IDA-10 into

effect. May I request Ministers to act promptly in this regard? IDA must become effective this summer if its operations are not to be disrupted.

32. During the course of the IDA-10 negotiations, donors expressed strong endorsement of IDA's main programmatic objectives, including those of poverty reduction and environmental sustainability. Each of these areas has been marked by several new initiatives covering both IDA and Bank operations. This President's Report brings Members up to date on recent developments.

C. Poverty Reduction

33. The Bank and IDA have continued to intensify their broad array of activities designed to help borrowers more effectively confront their poverty-reduction challenges along two key dimensions: (i) explicitly incorporating poverty-reduction objectives into country assistance strategies; and (ii) increasing lending which concentrates on promoting broad-based growth, providing the poor with access to physical infrastructure and basic social services, and eliminating policy distortions that adversely affect the interests of the poor.[3/] In addition, greater support is being given to the design and establishment of safety nets to protect the most vulnerable members of society during adjustment and/or transitional phases of lending operations.[4/]

34. Poverty assessments are essential to the formulation of country assistance strategies that incorporate a greater concern for poverty reduction. In many cases, their findings have been useful in designing assistance strategies that support and complement country efforts to promote efficient growth, expand access to social services, and strengthen safety nets. Considerable Bank/IDA staff resources have been devoted to the preparation of such assessments in recent years, resulting in the completion to date of 19 assessments. The pace at which they are

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[3/] *See, "Implementing the Bank's Poverty Reduction Strategy: Progress and Challenges," Report No. R92-233, World Bank, December 30, 1992.*

[4/] *The most common safety nets have been nutrition programs, labor-intensive public works, and targeted food subsidies.*

being prepared is accelerating, and by the end of FY95, poverty assessments are scheduled to be completed in 80 countries.

35. Progress can also be reported in lending directions. The Bank's support for economic policy reforms is focussed on encouraging economy-wide and sectoral policies that stimulate the demand for rural and urban labor. Lending is also concentrating more on human resource development and the extension of basic social services, such as primary health care and primary education, with special emphasis on the needs of women in both income-generating and social sectors. Bank lending is supporting both an enhanced focus on services for the poor as well as an improvement in the quality of such services. Investment lending for human resource development, for example, has increased almost fivefold over the past decade -- from an annual average of about $635 million in FY80-82 to over $3 billion per annum in FY90-92 or about 14 percent of total Bank/IDA lending. Another measure of lending, the Program of Targeted Interventions,[5/] included 52 projects in FY92 in a wide range of sectors: agriculture and rural development; education; water supply and sewerage; and population, health, and nutrition. The total value of these interventions amounted to 14 percent of new Bank/IDA lending in FY92. Meanwhile, an increasing share of Bank/IDA structural and sectoral adjustment lending included an explicit poverty focus. In FY92, eighteen adjustment loans supported the reorientation of public expenditures, the establishment of safety nets, and/or the elimination of distortions affecting the poor.

36. An integral part of the poverty-reduction agenda is an intensified effort to enhance the role of women in development (WID), and efforts are on-going to integrate WID activities more fully into the full range of the Bank's operations.[6/]

D. Environmental Activities Since UNCED and the World Bank's Role

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[5/] *Targeted interventions are investment operations which include a specific mechanism for reaching the poor, and/or those operations in which the participation of the poor exceeds the proportion of the poor in the population as a whole.*

[6/] *WID activities will be discussed in more detail in a future progress report to the Development Committee.*

37. Another key aspect of IDA's programmatic emphases repeatedly stressed during the course of the IDA-10 negotiations was its support for environmentally sustainable development. Since the historic UNCED meeting in Rio de Janeiro last June -- and despite the lack of consensus on an Earth Increment for IDA-10 -- IDA and IBRD have accelerated their activities designed to help recipients meet their formidable environmental challenges. In so doing, the World Bank is making significant contributions to the follow-up work to UNCED in support of the recommendations contained in its broad-ranging Agenda 21 plan of action. The Bank's work has been facilitated by the recent internal reorganization which included the establishment of a new Vice-Presidency for Environmentally Sustainable Development. The following are some highlights of recent Bank/IDA environmental work:

- The number of World Bank loans and credits promoting environmental stewardship continues to rise, with notable increases in lending for country-level institution-building and for better management of critical natural resources.

- The Bank and IDA have also continued their policy support and provision of technical assistance to member countries for elaboration of their national environmental action plans. Every effort is being made to assist IDA borrowers to complete such plans by June 30, 1993, in response to the commitment made by the Bank in the IDA-9 Agreement. The Bank also is giving priority to incorporating the findings of such plans into country assistance strategies. Ten IDA countries have completed environmental action plans and another nineteen, including major borrowers such as China and India, are expected to complete theirs by the end of FY93. The bulk of the remainder, most of which are in Africa, are now scheduled for completion in FY94. While this slippage, which is due mostly to difficult country conditions, is regrettable, it needs to be recognized that preparation of environmental action plans must be country-driven and participatory if environmental concerns are to be fully integrated into borrowers' development strategies.

- Regional environmental planning efforts are also underway in the Caribbean, in Central and Eastern Europe, in the Mediterranean region (in collaboration with the European Investment Bank) and in South Asia. Related work in support of sector-specific strategies is being undertaken in such areas as

biodiversity (beginning with a regional strategy for Asia) and coastal zone guidelines (pursuant to Chapter 17 of Agenda 21).

• Following a review of the first two years of the environmental assessment process, increased priority is being given to help borrowers strengthen local capacity to conduct environmental assessments and implement mitigation measures. In addition, technical assistance is being given to address potentially adverse social impacts of Bank and IDA-supported projects, particularly in resettlement.

• Environmental economics research in support of lending operations is being expanded. For example, analytical techniques are being developed to link economic activity more integrally with the environment, and incentive systems for environmental improvement are being developed. In addition, the Bank is analyzing the links between the environment and adjustment policies and trade policies, respectively, to ensure that economic reforms are, to the extent possible, consistent with environmental concerns.

38. The Global Environment Facility (GEF). The Global Environment Facility[7] was endorsed by UNCED (Chapter 33 of Agenda 21) as an important instrument for integrating global environmental concerns into the development process. More specifically, the Climate Change and Biodiversity Conventions designated the Facility as the interim funding mechanism for helping developing countries meet agreed incremental costs of implementing the conventions. The Facility's pilot phase ends late this year, by which time the resources originally contributed (some $1.3 billion) will have been committed.

39. The Facility is currently being restructured, and participating governments have endorsed the objective of universal membership. Efforts are underway to establish appropriate decision-making procedures and to articulate fully the Facility's linkages to the international conventions.

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[7] *Established in 1990 on a three-year pilot basis, the GEF is jointly implemented by the United Nations Development Programme, the United Nations Environment Programme, and the World Bank. GEF resources are available for projects that address global warming, pollution of international waters, destruction of biological diversity, and depletion of the ozone layer.*

40. The Facility's replenishment process began early this year and negotiations will run parallel with those on its restructuring. Several countries have proposed that the new GEF should increase significantly in size. It is essential that adequate resources be made available for the successful implementation of the conventions and that the GEF replenishment be completed expeditiously, following an evaluation of the pilot phase.

41. Institutional Developments. Highly cognizant of UNCED's call for nongovernmental organizations (NGOs) to be recognized as partners in the implementation of Agenda 21, the Bank and IDA continue to increase their cooperation with them, particularly at the local level. A $5 million grant window for NGOs, administered by UNDP, has been established under the GEF to support NGO initiatives in biodiversity. We have also consulted a number of external organizations, including NGOs, on ongoing reviews of Bank policy relating to forestry, energy conservation, and power and water-resources management.

42. To improve cross-sectoral, interagency cooperation at the country level and around specific programs and policies, the Bank will play an active role in the newly-formed Interagency Committee on Sustainable Development of the UN's Administrative Committee on Coordination and expects to collaborate closely with the new Department for Policy Coordination and Sustainable Development in the UN Secretariat.

E. Portfolio Management Task Force and the Quality of Bank/IDA Lending

43. Lending in support of priority development objectives -- whether from IBRD, IDA or other sources both private and official -- is important. Many developing countries will have great difficulty in attaining sustained growth, reducing poverty, and protecting the environment without the crucial supplement to domestic savings and investment provided by foreign capital. The quality and effectiveness of external assistance are also crucial, however. Effectiveness has always been a prime concern; in an era of financial constraints, it clearly takes on even greater importance.

44. Shortly after assuming the Presidency of the Bank in September 1991, I reviewed its main policies and priorities and

concluded that they were basically sound and on the right track. There were questions, however, about how the effectiveness with which they were being implemented could be heightened. Clearly, it is incumbent upon the Bank to ensure continuously that its loans actually produce the benefits for its borrowers that are anticipated at the time they are approved by the Board of Executive Directors.

45. With this in mind, in February 1992 I asked Mr. Willi Wapenhans, a senior manager of the Bank with many years of operational experience, to lead a Task Force on Portfolio Management to examine the quality of the Bank's portfolio and make recommendations, where required, on measures needed to improve it further. After extensive analysis of extant materials, examination of best practices in the Bank's operational complex, and three international workshops with borrowers, cofinanciers and contractors, the Task Force issued a comprehensive report that was transmitted to Executive Directors in October 1992. Because of its importance, I want to give you a brief overview of the main conclusions of the portfolio management report and the efforts under way to improve the quality and effectiveness of the Bank's portfolio and its future lending operations.

46. The Bank measures its portfolio performance through two main instruments. First, it maintains a system of ratings during project execution. The Task Force found on the basis of these ratings that more than 75 percent of Bank-financed projects demonstrate good performance during implementation. An average 20-25 percent incidence of projects in difficulty is not particularly high for a development institution like the Bank. As the report notes, a lower incidence might suggest that we were not taking enough risks in what is fundamentally a high-risk business. Moreover, ratings during implementation are designed as a warning signal to prompt corrective action. Projects frequently move from being "problem projects" to "good" ones, following such corrective action; and vice versa, when implementation deteriorates. Moreover, many "problem" projects achieve a large proportion of their physical and institutional objectives.

47. Second, the Bank measures portfolio performance at project completion, when the actual rate of return in real terms (or its qualitative equivalent) is compared with the estimated rate of return at the time of Board approval. The Bank sets itself

rather high standards in this regard, requiring of all projects that enter the portfolio a minimum 10 percent rate of return in real terms (or its equivalent in qualitative terms when quantification is not feasible). In the most recent Annual Review of Evaluation Results by the Operations Evaluation Department (OED)[8], the average re-estimated economic rate of return (ERR) at project completion (for 120 operations in sectors in which ERRs are normally used), weighted by actual project cost to indicate the return on total investment, was an impressive 16 percent. Most ex-post rates of return for projects reviewed by OED in the 1991 evaluation were in the 10-20 percent range.

48. Nevertheless, there has been a decline in the quality of the portfolio by both measures. The share of projects with "major problems" during implementation rose from 11 percent in FY81 to 18 percent in FY92, while the proportion of projects judged satisfactory by OED in its annual evaluation fell from 85 percent in FY81 to 63 percent in FY91. The decline in performance is apparent across a number of sectors and countries. The Task Force notes that the most important elements contributing to the deterioration in the quality of the portfolio were the international economy and country-specific factors. At the international level, declining terms of trade, rising global interest rates, and high world inflation eroded project viability. At the country level, macroeconomic conditions and policies, changes in development priorities, deficient incentive and regulatory environments, and weak or declining institutions contributed to project performance. Most of the deterioration in project performance since the early 1980s can be accounted for by developments in the external environment and country growth rates (which slowed down for many countries).

49. Other factors are more specific to Bank operations, however. One is the strong attention paid by the Bank and its member governments to new lending commitments -- and, on the other hand, insufficient attention to the effective implementation of the programs and projects that the Bank finances. This is reflected in the need to simplify projects and enhance their quality at the time of their entry into the portfolio, including more emphasis on assessing the risks that an operation may face, and the need to ensure that borrowers "own" the projects and are committed to their effective implementation. Evidence that this

[8] *Report No. 11062, World Bank, August 21, 1992.*

is not always the case is that the covenants included in loan agreements with borrowers -- provisions intended to ensure effective implementation -- too often are not met.

50. The Task Force's fundamental conclusion -- with which I concur fully -- is that the Bank needs to modify some of its key institutional values that shape its approach to all facets of its lending operations. The Bank's "culture" should become more attuned to the on-the-ground net benefits as the measure of success and not just the volume of lending, important as that is. It concludes -- and again I agree -- that the status of the Bank's portfolio can be improved and its services to its borrowers strengthened through a wide array of changes in project preparation and appraisal, loan processing, procurement, supervision, and evaluation. Solutions to the problems identified by the report will require collaborative effort by shareholders, particularly in their capacity as borrowers; cofinanciers; and the Bank.

51. The Bank's Executive Directors have endorsed the general thrust of the Task Force's analysis, conclusions, and recommendations. Taken together, the Task Force's findings and suggestions provide highly useful guidance for how all providers of external resources for development might better ensure their effective deployment.

52. The task ahead is to incorporate the report's recommendations into the on-going business practices and processes of the Bank. Much has already been done. In recent years, various actions have been taken by the Bank's regional departments to improve performance, including portfolio restructuring, greater use of disbursement suspensions, country strategy and implementation reviews, and increases in resources for portfolio management. In FY92, for example, country implementation reviews for 20 of the 39 large-country portfolios were conducted. Restructuring of country portfolios was intensified in all regions in FY92, especially in those with a high incidence of problem projects. All regions have strengthened their efforts to deal with some of the most common implementation problems, particularly procurement and audits.

53. Considerably more needs to be done, however. The Bank's Board has met several times to discuss the report's findings and recommendations, and a document entitled "Portfolio Management:

Next Steps"[9] has been circulated to the Bank's Board for its consideration. This entails changes in numerous operational practices -- such as more systematic consideration of portfolio performance in business practices, including in the formulation of country assistance strategies; monitoring project performance beyond the disbursement stage; greater emphasis on participation by those affected in the design and implementation of Bank-financed projects; and the development of methodologies to better assess project risks at the time of entry into the portfolio and to better measure the development impact of projects in the portfolio. I am confident that our members will support the efforts to enhance further the effectiveness of Bank lending.

IV. Conclusion

54. The challenges confronting developing countries are numerous and complex. In meeting them, the single most important short-term response would be an early and successful conclusion to the Uruguay Round. Adequate volumes of external finance are equally essential; and so are greater efforts to improve the effectiveness with which they are used. If access to markets improves, private flows continue their recent increase, and if official flows -- especially of a concessional nature -- can be augmented and their quality enhanced, the international community can look forward to solid progress in sustaining growth, reducing poverty, and protecting the environment in the remainder of this decade. Of course, such resource flows can only supplement the efforts of the developing countries themselves -- efforts which the World Bank Group will continue to support with all the resources, financial and nonfinancial, at its disposal.

[9] *Report No. R93-62, World Bank, April 5, 1993.*

Annex Table 1. Long-Term Aggregate Net Flows of Resources to Developing Countries 1/
($ billion, 1992 prices)

Type of Flow	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992 2/
Official Development Finance	43.5	43.3	45.7	48.7	44.7	41.0	43.6	58.0	56.6	60.3
ODA	27.1	26.0	33.1	35.7	39.0	35.8	37.4	43.4	43.3	43.9
Official Grants 3/ 4/	12.6	14.6	18.7	20.3	20.0	20.6	20.9	27.8	30.0	30.0
Official Concessional Loans	14.5	11.4	14.5	15.5	18.9	15.2	16.6	15.7	13.3	13.9
Official Nonconcessional Loans	16.4	17.3	12.6	13.0	5.7	5.2	6.2	14.6	13.4	16.4
Private Flows	50.6	40.3	41.0	29.4	31.7	44.2	42.0	41.5	50.4	67.7
Private Loans	36.8	26.4	22.7	12.2	10.0	16.5	11.4	11.4	11.1	23.9
Foreign Direct Investment 5/	10.8	10.6	14.5	12.9	16.7	22.7	26.1	25.1	34.1	38.3
Private Grants 3/	2.9	3.3	3.8	4.3	4.9	5.0	4.5	5.1	5.2	5.5
AGGREGATE NET FLOWS	94.1	83.6	86.7	78.1	76.4	85.2	85.7	99.6	107.0	128.0
Memorandum Items:										
Interest Payments, Loan Charges, Reinvested and Remitted Profits	73.4	81.2	87.4	83.0	80.6	86.1	77.9	70.4	72.9	72.6
Related Data:										
IMF - Net Flows 6/	14.0	5.8	-0.3	-3.2	-7.1	-6.4	-2.6	0.1	3.1	-0.2
Technical Cooperation Grants 3/	8.7	9.1	11.2	11.3	12.8	13.6	10.5	10.8	10.6	11.4
Portfolio Equity Investment 7/	0.0	0.0	0.0	0.0	0.0	0.0	3.9	4.0	7.6	8.1
Memorandum Items: 8/										
World Bank - Net Flows	7.1	7.7	7.0	7.3	5.9	3.3	3.1	5.3	2.5	3.6
IDA - Net Flows	2.9	3.2	3.7	4.0	4.6	4.3	3.6	4.3	4.2	4.9

1. One hundred and sixteen (116) developing countries for which data are reported in the 1992-93 edition of the World Debt Tables.
2. International Economics Department, Debt and International Finance Division (IECDI) projections.
3. OECD data (through 1991).
4. Excludes technical cooperation grants.
5. IMF balance of payments data, which include reinvested profits.
6. Includes IMF Trust Fund, SAF and ESAF.
7. World Bank staff estimates (available from 1989 onwards only), which are derived from reported market transactions and are often available only on a gross flows basis.
8. The World Bank and IDA net flows data are on a calendar year basis. The historical data differ from more widely reported fiscal year data only because of the different aggregation period.

Note: The data presented in this table differ from the Annex Tables in the previous President's Reports due to the use of the import unit value index from the IMF World Economic Outlook to deflate the values instead of the OECD deflators, and the change in base prices, from 1990 to 1992 prices.

THE WORLD ECONOMIC SITUATION AND ECONOMIC TRENDS IN DEVELOPING COUNTRIES
STATEMENT BY MICHEL CAMDESSUS
MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

World Economic Outlook

1. Notwithstanding the current weakness of activity in Japan and Europe, the external economic environment for most developing countries is expected gradually to improve during the period ahead (see table). Industrial country activity and the growth of world trade are expected to strengthen, and non-oil commodity prices are likely to recover. While U.S. dollar interest rates are likely to rise as economic recovery takes hold--but not to levels prevailing in 1990-91--European interest rates are expected to decline. Oil prices are expected to fall in 1993, reducing costs for most developing countries but adversely affecting fuel-exporting countries. The outlook for world growth and trade reflects a pickup in industrial countries and assumes sound financial and structural reform policies in developing countries. The projections also assume that increased protection will be avoided through efforts to achieve a more open multilateral trading system.

2. World economic activity in 1992 was weaker than anticipated as real output increased by only 1 3/4 percent. In the industrial countries, the United States and Canada experienced a moderate recovery from recession, but growth weakened significantly in Japan and Europe. In the developing countries, output expanded significantly in the Middle East in 1992 and growth remained high in Asia. Among the countries in transition, the sharp contraction of output ended in a number of central European countries in 1992, although in the former Soviet Union there were larger declines in economic activity.

3. In 1993 world output is projected to expand 2 1/4 percent as higher growth in Canada, the United States, and the United Kingdom, and a less severe decline in output in the countries in transition, is expected to more than offset somewhat slower growth in the developing countries and many industrial countries. The recent stimulus package in Japan is expected to sustain growth in 1993, albeit at a relatively modest pace of 1 1/4 percent. Output in Europe is expected to be stagnant in 1993, and in West Germany alone it is expected to fall by 2 percent. However, as the business cycle turns around, the growth of world output is expected to strengthen further in 1994 to 3 1/2 percent as activity rebounds in Japan and Europe and the contraction of output in the countries in transition abates.

4. The volume of world trade rose by 4 percent in 1992, following a 2 1/4 percent increase in 1991. This increase was spurred by the continued expansion of intraregional trade among Asian countries and by somewhat higher import growth in the industrial countries. The growth of world trade

is projected to rise to 5 percent in 1993 and 5 3/4 percent in 1994 as activity recovers further in the industrial countries.

5. The aggregate terms of trade of developing countries declined 3 3/4 percent in 1991 and fell by a further 1 1/2 percent in 1992. The deterioration in the terms of trade in 1992 was most severe in Africa and the Middle East and Europe, reflecting higher import prices and the continued declines in some primary commodity prices (which, for some are at the lowest nominal levels since the 1970s). The terms of trade of developing countries are expected to decline by 1 percent in 1993 and remain unchanged in 1994. Lower oil prices in 1993 are projected to be reflected in a drop of 2 1/4 percent in the terms of trade of fuel exporters, bringing the cumulative decline since 1991 to about 20 percent. The projected terms of trade for exporters of nonfuel primary products are expected to remain roughly constant in 1993 and improve marginally in 1994.

6. Both short- and long-term interest rates--abstracting from the immediate effects of the exchange-rate turmoil in Europe--have tended to decline in 1992, owing to weak growth in industrial countries, declining inflation, and strengthened commitments to fiscal consolidation in several industrial countries. During 1993 short-term interest rates are expected to decline significantly in Europe and Canada, to remain close to current levels in Japan, and to begin to firm in the United States.

7. Notwithstanding the continued economic difficulties in many countries, there is considerable potential for improvement in the global outlook in the second half of the 1990s. Realizing the full potential of these medium-term opportunities will require broadly based cooperative efforts emphasizing control of fiscal deficits, a continued commitment to low inflation, further liberalization of trade, and removal of obstacles to higher investment--both domestic and foreign--and to efficient resource allocation. Determined pursuit of such policies would lay the foundation for sustainable increases in growth and living standards worldwide. Conversely, a failure to take advantage of these opportunities would risk exacerbating the continued sluggishness of growth in the industrial countries in the short run and would markedly weaken the medium-term outlook.

Economic trends in the developing countries

8. Growth in the developing countries strengthened in 1992 to 6 percent, led by buoyant activity in Asia and a strong pickup in the Middle East, reflecting reconstruction and a recovery of oil production following the 1990-91 regional crisis. Output growth is expected to moderate to about 5 percent in 1993-94 as activity in the Middle Eastern countries returns to more normal levels. Increases in output are projected to remain high in Asia in 1993-94, assuming the current slowdown in Japan does not seriously affect export growth in the region. The projections also assume that structural reforms that have been implemented recently in Bangladesh, India,

and Pakistan spur growth in these countries. Activity is expected to strengthen in Africa in 1993-94, on the assumption of continued reforms and sound financial policies in countries that are using the IMF structural adjustment facility (SAF) or enhanced structural adjustment facility (ESAF), and assuming normal rainfall in southern Africa. In the developing countries of the Western Hemisphere, growth is expected to remain comparatively low, largely because of weak activity in Brazil associated with difficulties in implementing sound macroeconomic policies. However, other countries in the region that have implemented stabilization and structural reform efforts are expected to continue to grow at more satisfactory rates.

9. The aggregates for developing countries mask substantially differing growth rates within regions. Divergences in growth among developing countries have tended to widen in recent years, as many countries have failed to register meaningful improvement in economic conditions. The stronger performers share a number of essential characteristics. Compared with the slow-growing countries, the successful countries have markedly higher saving rates; higher investment rates, including investment in human capital; and more efficient investment and higher overall productivity growth. They also typically finance a larger proportion of investment from domestic saving; when they have recourse to external saving, it is often in the form of foreign direct investment and equity capital rather than debt-creating capital inflows. Finally, these countries are generally more outward-oriented--as characterized by the maintenance of competitive exchange rates and liberal trade and payments systems--than the low-growth countries. Many developing country exporters have weathered the current sluggishness of growth in the industrial world by expanding their trade with other developing countries.

10. Average inflation in the developing countries was halved to about 37 percent in 1991-92 and is projected to decline further to about 34 percent in 1993; the more representative median inflation rate has declined steadily over the past four years and is expected to be 5 percent in 1994, the lowest in over two decades. In Africa, inflation is expected to decline significantly due to the reduction in fiscal deficits in several of the large countries. Inflation in Asia remains at relatively low levels, although there is a risk of overheating in some countries. In the Western Hemisphere, inflation is expected to decline in most countries, but to remain very high in Brazil due to difficulties in implementing a macroeconomic stabilization program.

11. After rising by 7 3/4 percent in 1991, the volume of developing country exports increased nearly 8 1/2 percent in 1992 spurred by the continued expansion of intraregional trade in Asia and somewhat stronger import demand in the industrial countries. High export volume growth is projected to continue in 1993-94 as growth in the industrial countries strengthens. Exporters of manufactures are likely to see growth of over 10 percent for the third consecutive year, implying an increase in their market shares. In countries that export mainly nonfuel primary products,

export volume growth is expected to increase from 2 1/4 percent in 1992 to 6 1/4 percent in 1993-94, reflecting primarily a pickup of activity; export volumes for fuel exporters are expected to increase about 6 1/2 percent in 1993-94.

12. The aggregate current account deficit of the developing countries narrowed somewhat to $78 billion in 1992 due primarily to the substantial reduction of the current account deficit in the Middle East. Current account deficits widened, however, in Asia and the Western Hemisphere reflecting relatively strong demand growth, strong foreign direct investment, and significant trade liberalization in several countries. Many of these countries are experiencing a renewal of market access and significant capital repatriation. The current account deficit widened in Africa due to adverse terms of trade movements and an increase in imports following the drought in 1991. The aggregate current account deficit for all developing countries is expected to narrow marginally in 1993-94 as industrial countries' import demand strengthens.

13. The total external debt in terms of U.S. dollars of developing countries rose by only 2 percent in 1992. The aggregate debt to export ratio fell 7 percentage points, to 120 percent, in 1992. A further drop of 15 percentage points is expected by 1994, reflecting in part an increase in exports; the aggregate debt-export ratio will then be about the same as it was in 1982. Aggregate debt in the Western Hemisphere rose only slightly in 1992, owing mainly to a number of debt-reduction operations. The debt-export ratio in the region fell 8 1/2 percentage points, to about 250 percent. Debt-export ratios also improved in Asian developing countries, where continued strong export performance was combined with modest borrowing. Africa's debt-export ratio fell only slightly, to 229 percent, mainly due to continued official lending to sub-Saharan countries.

14. Significant debt-restructuring agreements were completed in 1992, involving restructuring of commercial bank debt totaling $35 billion and a net reduction of arrears of $15 billion, concentrated largely in the Western Hemisphere. Major agreements included a debt-restructuring package with the Philippines and an agreement to restructure Argentina's foreign debt. These agreements are financed in part by the allocation of about $1 billion from the IMF. Brazil reached agreement on a term sheet for a comprehensive bank debt package which was recently presented to creditors. In addition, progress has been made to complete buybacks for low-income countries, including Bolivia, Guyana, and Uganda, while several agreements were concluded with official creditors in the context of the Paris Club offering debt relief under enhanced concessional terms for several low-income developing countries.

* * *

The IMF staff has adopted a new set of weights for aggregation of output across countries based on estimates of purchasing power parity (PPP). An important difference compared with the previous weights, which were based on market exchange rates, is that the developing countries' share of world output increases significantly. Because of this change, world and regional aggregates reported in this note are not directly comparable with those shown in earlier notes. The rationale for and implications of introducing PPP-based weights are discussed in Annex IV of the forthcoming *World Economic Outlook*.

Major Economic Indicators

(Annual changes in percent, except where noted)

	1990	1991	1992	1993	1994
World					
Real GDP growth	2.0	0.6	1.8	2.2	3.4
Trade volume	4.4	2.3	4.1	5.2	5.6
Trade Prices					
Fuel	28.2	-17.0	-0.5	-3.0	2.6
Nonfuel primary commodities 1/	-7.7	-4.5	-0.1	1.3	3.1
Manufactures	9.0	-0.5	3.7	-3.0	2.0
Six-month dollar LIBOR (percent)	8.4	6.1	3.9	3.8	5.3
Industrial countries					
Real GNP growth	2.1	0.2	1.5	1.7	2.9
Inflation	5.2	4.5	3.2	3.0	3.0
Import volume growth	4.6	2.5	4.0	3.9	4.7
Developing countries					
Real GDP growth	3.7	4.2	6.1	5.1	5.1
Inflation	65.4	35.7	38.7	33.6	20.0
Inflation (median)	10.4	10.0	9.0	6.0	5.0
Current account (in billions of U.S. dollars)	-21.3	-81.9	-78.4	-74.4	-75.6
Current account (in percent of exports)	-2.1	-7.7	-6.8	-5.9	-5.4
Export volume growth	6.0	7.7	8.4	9.7	8.8
Import volume growth	7.3	9.1	10.2	8.6	8.3
Terms of trade	2.1	-3.8	-1.4	-1.0	-0.1
Export unit value	6.8	-2.1	1.3	0.5	2.1
Import unit value	4.6	1.8	2.8	1.6	2.3
Debt (in billions of U.S. dollars)	1276	1355	1386	1424	1477
Debt (in percent of exports)	126.9	126.8	119.9	112.3	105.5
Debt service (in percent of exports)	14.2	14.4	14.8	14.2	13.0
By region					
Africa					
Real GDP growth	1.9	1.5	0.9	2.7	3.9
Inflation	16.9	32.2	40.2	16.8	9.9
Current account (in percent of exports)	-2.3	-4.0	-8.0	-6.7	-8.3
Export volume growth	6.5	1.6	1.4	4.0	3.1
Import volume growth	2.8	-3.0	3.3	2.2	4.6
Terms of trade	3.0	-5.5	-5.5	-2.8	-0.8
Debt (in percent of exports)	219.6	230.4	229.1	226.7	226.3
Asia					
Real GDP growth	5.7	5.8	7.9	6.7	6.6
Inflation	7.6	8.5	7.4	7.4	6.5
Current account (in percent of exports)	-1.1	-1.1	-3.2	-3.7	-2.7
Export volume growth	8.2	11.8	11.1	11.8	11.1
Import volume growth	8.3	11.2	12.0	11.9	9.9
Terms of trade	-1.4	-0.7	-0.4	-0.9	-0.3
Debt (in percent of exports)	69.8	69.3	64.7	61.4	57.7
Middle East and Europe					
Real GDP growth	3.9	2.1	9.9	5.0	3.5
Inflation	23.8	23.8	20.6	25.0	21.5
Current account (in percent of exports)	-2.6	-25.5	-7.3	-3.0	-3.1
Export volume growth	1.1	2.2	6.1	8.3	5.7
Import volume growth	6.5	3.8	1.8	3.1	5.5
Terms of trade	14.1	-11.1	-3.3	-1.1	0.1
Debt (in percent of exports)	124.4	134.6	132.8	125.6	117.6

Major Economic Indicators (Concluded)

(Annual changes in percent, except where noted)

	1990	1991	1992	1993	1994
Western Hemisphere					
Real GDP growth	0.4	3.1	2.3	2.3	2.6
Inflation	478.9	135.9	169.9	150.8	68.1
Current account (in percent of exports)	-4.1	-10.8	-18.7	-17.2	-17.3
Export volume growth	4.4	4.2	4.3	6.0	5.7
Import volume growth	7.8	16.5	18.0	4.4	6.0
Terms of trade	-0.6	-4.0	-0.6	-0.2	0.8
Debt (in percent of exports)	250.9	257.9	249.7	231.3	220.6
By analytic criteria					
Countries with recent debt-servicing difficulties					
Real GDP growth	0.3	1.9	2.4	2.8	3.1
Inflation	226.6	92.4	111.2	92.1	46.2
Current account (in percent of exports)	-7.3	-10.3	-15.4	-13.8	-14.3
Export volume growth	-0.1	-0.8	4.3	8.0	6.4
Terms of trade	1.4	-5.6	-2.2	-0.6	0.4
Countries without recent debt-servicing difficulties					
Real GDP growth	5.7	5.4	7.7	6.3	6.4
Inflation	9.8	11.0	10.7	9.5	8.3
Current account (in percent of exports)	-2.9	-2.3	-2.9	-3.2	-3.1
Export volume growth	8.2	10.6	11.6	11.7	11.0
Terms of trade	--	-0.2	-0.3	-1.0	-0.3
Fuel exporters					
Real GDP growth	4.0	3.9	7.1	4.2	4.0
Inflation	17.1	16.9	16.0	14.2	10.2
Current account (in percent of exports)	-1.5	-25.7	-16.8	-12.2	-11.4
Export volume growth	4.0	4.3	4.9	7.7	5.9
Terms of trade	15.7	-12.4	-3.2	-2.3	--
Exporters of nonfuel primary products					
Real GDP growth	2.0	3.0	3.9	4.3	4.6
Inflation	183.5	87.9	44.4	23.9	15.1
Current account (in percent of exports)	-13.1	-16.4	-24.1	-21.7	-20.8
Export volume growth	11.0	3.6	2.3	6.9	5.5
Terms of trade	-6.3	-3.0	-1.1	0.1	0.7
Exporters of manufactures					
Real GDP growth	4.1	4.9	7.2	5.9	5.8
Inflation	94.2	43.1	59.0	55.0	30.0
Current account (in percent of exports)	0.1	1.1	-0.5	-1.3	-1.0
Export volume growth	5.7	10.9	11.1	11.3	10.7
Terms of trade	-2.1	--	-0.4	-0.8	-0.3

1/ In U.S. dollars. Averages weighted by 1979-81 commodity shares in exports of developing countries or groups of countries.

STATEMENT BY THE CHAIRMAN OF THE INTERGOVERNMENTAL GROUP OF TWENTY FOUR ON INTERNATIONAL MONETARY AFFAIRS MOHAMMED IMADY, MINISTER OF ECONOMY AND TRADE OF SYRIA

It is a distinct privilege and high honor for me to address this meeting of the Development Committee on behalf of the Intergovernmental Group of Twenty-Four on International Monetary Affairs.

Mr. Chairman,

The Group of Twenty-Four concentrated their deliberations on the main issue on your agenda today -- developing country access to private capital flows. In view of the worldwide interest of policy makers in private sector development, this undoubtedly is a timely and welcome discussion.

On the format of the discussion, we particularly commend your initiative, Mr. Chairman, to solicit practical suggestions from outside experts. We have always urged that this Committee assume a truly action-oriented program. We hope that in future occasions, this practice will utilize the input of the business and financial community in developing countries.

On the substance of our discussion, let me say that we share the view that the encouraging improvement in the flow of direct and portfolio investments in the past two years has been concentrated in few countries and remain vulnerable to changes in the external environment. The bulk of developing world, especially the poorer countries, have not managed to attract private flows despite the reform programs put in place by a large number of these countries. This situation is not likely to change much any time soon; certainly not without proactive action by the international community. Our discussion at the Group of Twenty-Four identified two major areas where action needs to be intensified if we were to build a solid foundation for future private capital flows.

The first is in the area of official development assistance. These flows have unfortunately been stagnating and not much improvement can be expected especially if attention now shifts to private capital flows. Yet, for the bulk of low and lower-middle income countries, ODA is critical for their efforts to continue reform programs, build their infrastructure, and improve their human resource base. Without progress in these fields, it is not easy to envisage any meaningful inflow of private capital.

The Group of Twenty-Four has, therefore, underscored the need for donor countries to enhance their commitment to development assistance. Particular attention was drawn to achieving the following objectives:

- the 0.7 percent ODA target
- ratifying the IDA Tenth Replenishment
- providing concessional assistance for environmental programs
- and, funding of the Global Environment Facility.

The <u>second</u> major area where action needs to be intensified is the liberalization of international trade, particularly the successful conclusion of the stalled Uruguay Round. The documentation before you clearly demonstrates the relevance of an open trading system to promoting private capital investment. More generally, both Mr. Camdessus and Mr. Preston have pointed the dire consequences of a slide towards protectionism. We strongly share Mr. Preston's call on ministers to lend their considerable influence in their capitals to ensuring that the Uruguay Round is concluded successfully and promptly. I also share Mr. Dunkel's statement that we cannot believe that the world leaders will allow this prize to slip from their grasp. Let us hope that the recent efforts he told us about will lead to better news.

In turning to specific issues, Mr. Chairman, let me say first that the Group of Twenty-Four has followed the framework you suggested for discussing private capital flows to developing countries; namely to focus on action by the three main groups of players: the host countries, the source countries and the international financial institutions. The analysis we have received has indeed indicated that if action is taken by each of the main players we stand a much better chance of achieving good results.

The Group of Twenty-Four has noted the wide range of measures taken by the developing "host" countries to promote private sector development and attract private capital flows. We stressed that developing countries should pursue clearly defined strategies and adopt appropriate measures in cooperation with source countries and international financial institutions. We particularly pointed that a healthy domestic private sector in host countries is an essential requirement for accelerated private capital flows. We expressed interest in the suggestions of outside expert and called for expert studies to identify practical and feasible actions that may be submitted for future Development Committee consideration. On a more specific issue, we cautioned that the pace and manner of privatization should not be subject to undue pressures that might undermine the viability of the process.

On the role of industrial "source" countries, we pointed out that the documentation before us has indeed demonstrated that private capital flows can be facilitated substantially by industrial country measures. Apart from the obvious contribution that the reduction in fiscal imbalances and the increase in private savings can make to capital flows, a number of specific actions have been indicated. These include:

- easing the provisioning requirements on commercial banks
- more differential capital adequacy standards
- the elimination of discriminatory regulations and implicit tax disincentives.

We hope our industrial country colleagues will be able to put more effort in addressing these issues.

The role of international financial institutions in promoting private capital flows has been underscored, particularly with respect to assistance to low and lower-middle income countries, -- the "third tier" in your category, Mr. Chairman. We have commended the efforts so far undertaken by these institutions and pointed out to the new suggestions submitted to the Committee. Particular reference was made to suggestions:

- to expand World Bank guarantees, without impairing its lending capacity;
- establishing regional mutual funds
- help create an agency for private company rating in developing countries, and
- promoting the use of hedging mechanisms

On a broader issue, we have also drawn attention to the principles incorporated in the draft Code of Conduct for foreign investors undertaken by the UN. Taking these principles into account by foreign investors should help avoid unnecessary conflicts and insure that foreign investors respect the values and priorities of host countries.

Finally, Mr. Chairman, I look forward to an active follow-up of these matters by the Bank and the Fund, our Executive Directors and, of course, by future meetings of the Development Committee.

JOINT ISSUES PAPER
DEVELOPING COUNTRY ACCESS TO PRIVATE CAPITAL FLOWS

The attached paper, which has been prepared jointly by the staffs of the Bank and the Fund, discusses policies which could promote private capital flows to developing countries. It underscores the importance of sustained implementation of appropriate macroeconomic policies and market reforms in developing countries, while emphasizing the need for industrial countries to increase savings, notably by reducing fiscal imbalances, so as to assure better availability of resources to markets generally and developing countries in particular. Drawing on the attached paper, this covering note suggests some issues for discussion by the Ministers.

ISSUES FOR DISCUSSION

(i) A stable and prudent macroeconomic regime and an open trading environment are important in attracting foreign direct investment (FDI). Furthermore, freedom to remit dividends and repatriate capital, well-structured legal and regulatory frameworks, nondistortionary and transparent tax regimes, and efficient administrative and institutional arrangements are desirable to promote FDI. Ministers may wish to suggest specific actions that they have found productive in facilitating FDI in developing countries.

(ii) International portfolio investors may be deterred from investing in emerging markets in developing countries by risks related to illiquidity, lack of investor protection, and the limited availability of information. While progress has been made in a number of countries to address such difficulties, developing countries need to persevere with financial reforms aimed at increasing market efficiency and transparency, consistent with their stage of economic development. Ministers may wish to discuss where they see the priorities in raising regulatory and institutional standards in developing countries into line with those prevailing internationally.

(iii) The regulatory authorities in several creditor countries have responded to the improved situation of a number of developing countries by revising provisioning standards against bank exposure to those countries. It may be appropriate for other creditor countries to review the provisioning framework to avoid the existence of impediments to new bank lending while maintaining appropriate prudential standards. Consideration could also be given to establishing a more graduated risk-weighting system under the Basle capital adequacy guidelines, although such an exercise would raise difficult technical and political issues. Ministers may wish to discuss the scope for such revisions and what impact their implementation might have on commercial bank lending.

(iv) Developing country access to international securities markets may also be affected by regulatory policies and practices in industrial countries. Consideration may be given to reviewing regulatory provisions, including (i) quality restrictions applied to domestic markets; (ii) regulatory guidance provided to institutional investors on holdings of foreign assets; and (iii) restrictions on private placements, particularly for investor groups that are relatively sophisticated, and other measures that may help facilitate entry into international markets for less established borrowers. Any revisions to regulatory standards would have to be sensitive to the need to protect the small investor and maintain necessary prudential standards. Ministers may wish to comment on where they see regulatory impediments on portfolio flows to developing countries and on the feasibility of instituting changes without jeopardizing prudential standards.

(v) The international financial institutions' (IFIs) role in catalyzing private investment depends mainly on the importance that commercial lenders attach to such factors as the IFIs' knowledge and assessment of prospects for developing countries, the IFIs' capacity for project appraisal, and the degree of comfort that commercial banks may draw from cofinancing instruments (e.g., guarantees, sharing clauses, and lender-of-record arrangements). The effectiveness of such financing depends on its successful application to influence creditor perceptions of country risk in developing countries actively seeking to regain market access. Ministers may wish to express their views on the appropriateness and risks of current cofinancing and guarantee activities by the IFIs.

(vi) A number of developing countries are experiencing strong capital inflows which, besides implying a rapid build-up in external liabilities, can complicate economic management. In responding to these inflows, policy makers have a range of instruments available. The most flexible response to possible over-heating of the economy as a result of transitory inflows would be a tightening of monetary policy. However, this may be costly and eventually counterproductive. Fiscal adjustment is likely to be more effective at restraining domestic demand, although there may be practical limits to fine-tuning. If a lasting improvement in the efficiency of the traded goods sector of the economy has taken place, and improved market access is considered permanent in nature, a real appreciation of the exchange rate may be an equilibrating response. Direct controls to slow capital inflows are likely to be effective only temporarily (if at all) and may involve a cost by introducing distortions in the market. In practice, countries have faced difficult choices in balancing the trade-offs among these alternatives, especially given the uncertainties about the underlying causes and the permanence of the increased capital inflows. Ministers may wish to discuss the reasons for heavy capital inflows and the actions that developing countries may find appropriate in response.

(vii) The recent experience of private capital flows to developing countries has demonstrated the critical importance of the sustained implementation of appropriate macroeconomic and structural policies. Nevertheless, many countries in the low-income bracket--even those that have followed ambitious reform programs over a number of years--have not attracted substantial private flows, and the immediate prospects for such flows remains poor. Ministers may wish to comment on what, if anything, could realistically be done to improve these countries' access to private capital flows, and, more generally, on the need for concessional flows to support these countries' development efforts.

This paper was prepared by Charles Collyns, Shogo Ishii, and Susan C. Prowse, Program Development and Review Department, IMF; and Ronald L. Johannes and Kwang W. Jun, International Economics Department, World Bank.

DEVELOPING COUNTRY ACCESS TO PRIVATE CAPITAL FLOWS

(Prepared jointly by the staffs of the International Monetary Fund
and the World Bank)

I. INTRODUCTION

1. This paper explores issues related to developing country access to private capital flows that were raised in the paper on "Resource Flows to Developing Countries," discussed at the September 1992 meeting of the Development Committee. 1/ The paper first reviews the experience of developing countries with private capital flows in recent years. It then considers policies in developing and industrial countries to facilitate such flows, including to countries that have yet to gain (or regain) market access. The paper also examines the role of international financial institutions in this connection. The last section of the paper discusses prospects for private capital flows to developing countries. 2/

II. RECENT EXPERIENCE

2. After declining sharply following the 1982 debt crisis, private capital flows to developing countries began a steady recovery in the late 1980s, and have recently accounted for a rising share of total financial flows to these countries. 3/ Much of the recent increase in private capital flows has occurred through the international securities markets. Total bond issues in international markets by developing countries increased from an average of US$5 billion per year in 1987-90 to US$12 billion in 1991 and US$23 billion in 1992 (Table 1). Placements by developing country companies in international equity markets also grew rapidly, with funds raised by these companies increasing from US$1 billion in 1990 to US$5 billion

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1/ The term "developing country" as used in this paper refers to all low- and middle-income countries according to the World Bank classification.

2/ For further information, see "Private Market Financing for Developing Countries," IMF, December 1992, and "Global Economic Prospects and the Developing Countries, 1993," World Bank, February 25, 1993 (SecM93-207).

3/ The Development Committee paper on "Resource Flows to Developing Countries" (September 1992) provides a broad perspective on external finance for developing countries, including information on official and concessional flows which are outside the scope of the present paper.

in 1991 and US$7 billion in 1992 (Table 2). 4/ Although comprehensive statistics are not available, fragmentary information indicates that portfolio investment directly in local developing country markets--including short-term government paper as well as equity--also increased substantially during this period.

3. Recent portfolio flows have been concentrated in a small group of countries. Four Latin-American countries (Argentina, Brazil, Mexico, and Venezuela), which had lost market access in the aftermath of the debt crisis, accounted for over half of recorded portfolio flows to developing countries in 1991-92. China, Hungary, Korea, and Turkey accounted for a substantial share of funds raised by Asian and European countries. Low-income countries outside Asia, lower middle-income countries with unresolved debt problems, and most Eastern European and FSU countries in the early stages of transition have had virtually no access to international securities markets.

4. Although comprehensive information is not available on the investor composition of portfolio investment to developing countries, market participants report that such flows have mainly come from a limited range of investors. In the early stages of the market re-entry process, the largest source of capital flows to Latin American countries was reported to be returning flight capital. Over time, an increased role has been played by global investment funds and individual investors (particularly in the United States) attracted by high yields. By contrast, mainstream institutional investors, such as pension funds and insurance companies, still place only a small fraction of their portfolios in developing country securities, mainly in the largest Asian and Latin American markets.

5. Foreign direct investment (FDI) in developing countries has also increased sharply, from an average of US$17 billion (net) per year in 1987-90 to US$29 billion in 1991 and an estimated US$37 billion in 1992 (Table 3). While a wider range of countries has attracted such flows, the bulk of the increase has been directed toward Latin American market re-entrants as well as some Asian and European countries. Some economies in transition, notably the former Czechoslovakia and Hungary, that have made significant progress toward market reform, have begun to attract sizable FDI flows.

6. In contrast to portfolio and FDI flows, commercial bank lending to developing countries has remained largely stagnant in recent years. A large share of recent bank credit commitments is accounted for by Asian countries with good debt servicing records (Table 4). Bank lending to other developing

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4/ Many of these placements have been in the form of depositary receipts traded on industrial country stock exchanges.

countries, particularly those that had experienced or are experiencing debt servicing difficulties, has been limited, mainly confined to short-term trade financing and project financing.

III. POLICIES IN DEVELOPING COUNTRIES

7. A host country's policies are the main determinant of the amount and character of private capital flows that it receives. In this respect, consistent and stable macroeconomic policies are fundamental for establishing creditworthiness and fostering a private sector conducive to investment and attracting foreign capital in the form of both debt and equity. Particularly important are ensuring sustained growth of domestic savings, a low rate of inflation, a stable and realistic exchange rate, and the avoidance of relative price distortions. The recent experience of Latin America (e.g., Argentina and Mexico) suggests that markets can recognize and reward improvements in creditworthiness quickly. For a number of those countries, market-related restructuring of commercial bank debt has facilitated re-entry to international capital markets, while contributing to an environment in which strong policies were easier to sustain.

8. It is also important that the foreign exchange regime ensure ready access to foreign currency for imported inputs and freedom to remit dividends and profits and to repatriate capital. Foreign exchange controls remain, albeit to varying degrees, in a number of developing countries.Recent experience in Chile, Korea, and Pakistan has shown that the removal of such controls generates increased investor confidence and spurs investment inflows.

9. Appropriate macroeconomic policies and an open foreign exchange regime alone may not be sufficient for developing countries to sustain large private capital inflows. Equity flows in particular, whether portfolio or FDI, also depend on a healthy private sector which demands an adequate legal framework, transparent tax codes, and modern and cost-effective transportation and telecommunications. In some cases, regional integration conforming with multilateral standards can help to promote private sector development through creation of larger domestic markets and the coordination of infrastructure initiatives. In Asian and Latin American economies, well-established corporate sectors and extensive privatization programs have provided attractive investment opportunities. 5/

5/ It is estimated that roughly a quarter of total privatization proceeds, which amount to more than US$50 billion over the 1988-92 period, was financed by external capital flows, with the balance accounted for by debt/equity conversions and local financing.

By contrast, the lack of international investors' interest in some Eastern European and FSU economies has reflected in part the still rudimentary character of the corporate and financial sectors. In countries with a generally low level of economic development, private capital inflows have also been limited.

10. In a number of countries (e.g., Egypt, Hungary, and Venezuela), improved legal frameworks and investment codes have contributed to the growth of investment inflows. A clear definition of and protection for private property rights is particularly important. The recent guidelines on the legal treatment of FDI issued by the Development Committee 6/ advocate open admission policies, subject to certain clearly defined and permissible restrictions (e.g., national security); recommend national treatment (foreign and domestic investor to be treated equally as a general principle); and provide for the free transfer of profits, dividends, and interest payments, and for the repatriation of capital.

11. A clear and non-distortionary tax regime is an important consideration for foreign investment, whether portfolio or direct. The absence of a double taxation treaty increases the cost of foreign investment and thus deters foreign interest. A number of developing countries impose a capital gains tax that cannot be set off against source country liabilities, thus raising the cost to equity investors, particularly when the tax is not adjusted for inflation. Furthermore, the capital gains tax base is often not clearly defined and measured.

12. For foreign direct investment, weak institutions and obtrusive regulations discourage flows. Institutional problems are found in areas such as over-stringent bureaucracy and the involvement of too many institutions. In a number of countries (e.g., former Czechoslovakia, Mexico, and Thailand), the streamlining of inter-agency procedures and the creation of a single investment enabling agency have facilitated increased FDI, and similar arrangements could be considered elsewhere. In addition, inefficient regulatory structures for FDI often create distortions in the economy. Foreign interest can also be discouraged by high-cost public sector monopolies that raise the price of basic services, by limits on entry into certain sectors of the host economy, and by excessive restrictions on the freedom to employ expatriates. It is important for developing countries to sustain efforts to establish a transparent regulatory framework that is internationally competitive and does not discriminate between domestic and foreign investors.

6/ See the Development Committee paper, "Legal Framework for the Treatment of Foreign Investment," September 1992 (DC/92-13).

13. International portfolio investors are concerned about the risks inherent in emerging market transactions, especially those related to high volatility in prices, low liquidity and poor information. These factors have sometimes led to swings in portfolio flows, even while the underlying macroeconomic situation has remained fundamentally sound, as demonstrated by experience in a number of Asian stock markets. Despite a tremendous growth in recent years, developing country stock markets remain relatively small (e.g., few listed firms, limited market capitalization, and low turnover), and prices volatile. Efforts should be made to encourage market development by removing tax biases against public share offerings; improving trading systems (in particular, through lower commissions and reduced barriers to entry); and enhancing the reliability of clearance and settlement procedures. It also needs to be emphasized that a basic prerequisite for the development of efficient capital markets is a sound and competitive banking system, including the avoidance of interest controls that keep the cost of local bank borrowing artificially low.

14. Further risks to international portfolio investors arise because securities laws and investor protection laws in developing countries generally fall short of internationally acceptable standards; they are often either rudimentary or not rigorously enforced. 7/ National regulators in developing countries need to enforce contracts more strictly and to establish credible policing of insider trading. It is also important to strengthen accounting and disclosure standards to ensure the quality of information available to investors. Prudential regulations in the form of capital adequacy requirements for securities firms and margin requirements on trading also need to be strengthened to safeguard the integrity of the markets.

15. Terms of entry and exit may also affect the inflow of portfolio capital. In recent years, several developing countries--notably Argentina, Brazil, Colombia, Korea, Malaysia, and Pakistan--have liberalized registration procedures, and foreign investors can purchase listed stocks freely, albeit sometimes subject to a ceiling. Liberalization has been followed by considerable inflows. For example, in Korea net inflows amounted to over US$2 billion in 1992. Nevertheless, in many countries important barriers to entry into and exit from emerging securities markets remain.

7/ A recent IFC study shows that out of the 22 emerging markets, only six countries--Brazil, Chile, India, Korea, Malaysia, and Mexico--have investor protection laws of internationally acceptable quality. A few emerging market countries do not even have an agency for regulating stock market activities. See IFC Emerging Markets Factbook 1992.

16. Developing country borrowers looking to raise project financing--which inevitably requires relatively long commitment periods--have been faced with particularly severe lender concerns with credit risk. In some instances, these concerns have been addressed through carefully structured financing operations involving safeguards such as the channeling of export receipts into escrow accounts for future debt service payments. Such mechanisms have facilitated funding for private borrowers. For public projects, however, if the escrow account arrangements are not transparent and linked to the incremental revenues associated with the investment, their use may raise issues regarding the subordination of other creditors and the flexible management of foreign exchange by the borrowing countries.

17. Against this background, some developing countries have shown growing interest in non-recourse project finance. Under this arrangement, investors and creditors have recourse only to the security of the project, not to general public assets, although such projects may carry additional assurances from the host government (e.g., an undertaking on pricing in the power sector). A particular non-traditional type of project finance is the so-called BOT (Build-Operate-Transfer) scheme, which has been implemented in infrastructure projects--often in connection with privatization of public entities--in a number of countries, including Malaysia, the Philippines, Turkey, and Venezuela. 8/ However, the small number of completed projects suggests that interested external creditors find it difficult to overcome the complexities of country risk (representing not only sovereign risk but also a variety of specific local factors). There is also a concern on the part of host countries that BOT projects might bias incentives against longer-term economic benefits by shortening the project horizon. Countries--especially those that face a heavy public sector debt service burden--may want to consider how this type of financing may be structured, with possible support from the international financial institutions, so as to meet these concerns.

8/ The BOT, which was first developed in the 1970s, is a non-recourse project financing scheme under which one or more sponsors from the private sector form a special company to undertake a project. The sponsors typically include a major international engineering or construction firm, and one or more equipment suppliers. The project company raises the bulk of the financing required for the project from commercial lenders, including export credit agencies, and possibly bilateral and multilateral financial institutions. The essential feature of these agreements is that an attempt is made to separate project risk from country risk: lenders advance money against the cash flow of the project rather than the government's sovereign guarantee. The equity contribution of the consortium members might typically range between 10-30 percent of the total project cost.

IV. POLICIES IN INDUSTRIAL COUNTRIES

18. At a global level, the potential availability and cost of financing for developing countries depends on the balance between savings and investment in the industrial economies. The resurgence of private flows to developing countries in 1991-92 coincided with a period of weak demand in the main industrial economies and lower international interest rates. In the period ahead, these conditions are likely to be reversed as the global recovery gathers momentum. Policies that reduce fiscal imbalances and promote private savings in industrial economies will thus be important in determining whether adequate financing is available to developing countries.

19. The profitability of investment in developing countries is influenced by these countries' access to industrial country markets. Steps to promote an open international trading system, including through removal of import barriers, subsidies, and other market distortions, would help to foster an international environment conducive to capital flows to developing countries. A successful conclusion to the current Uruguay Round trade negotiations would be a critical step towards this objective.

20. As well as general macroeconomic conditions, private capital flows to the developing countries are also affected by financial market developments and policies in the industrial countries. The continued caution of international banks towards developing countries has reflected the difficult financial situations of many major banks and their efforts to adjust their balance sheets to meet the Basle capital adequacy standards, as well as concerns that, as in the 1980s, unsecured bank debt would be treated as a junior claim if countries encountered debt servicing difficulties in the future. In addition, provisioning requirements against exposure to countries that have experienced debt servicing difficulties increase the overall cost of funding new loans to these countries, and thus may hinder the resumption of bank lending.

21. Over the past year or so, regulatory authorities in a number of industrial countries have removed several countries--such as Chile and Mexico--from provisioning requirements and permitted lower provisions on others in response to their improved performance and prospects. Moreover, in other regulatory regimes, where greater reliance is placed on banks themselves to judge the appropriate level of provisions, provisioning has tended to decline against exposure to countries where creditworthiness has improved. Nevertheless, in some creditor countries further review of regulatory standards may be appropriate, to allow increased responsiveness to sustained good performance, while maintaining prudential standards. There may also be scope in some regimes to allow

greater differentiation between types of claim to reflect the varying degree of risk involved.

22. Concerns have been expressed that the international bank capital adequacy standards established under the Basle accord may discriminate against creditworthy developing country borrowers. Under the accord, a risk weight of zero is applied to claims on government borrowers in OECD/GAB countries, compared to a 100 percent risk weight on such borrowers in other countries. 9/ The higher risk weighting applied to these other borrowing countries tends to raise interest rate spreads and may generally deter new lending to these borrowers as banks look to increase their risk-weighted capital ratios. For that reason, suggestions have been made to refine the system of risk weights to provide risk categories that more closely reflect variations in creditworthiness. However, seeking such a modification would require reopening the Basle Accord and raise difficult issues of how to ensure adequate timeliness, reliability and coverage in credit risk assessments. Moreover, in view of the various factors that affect bank lending, the impact that such changes would have on lending to developing countries is uncertain.

23. Developing country access to international securities markets has been facilitated by the continuing trend toward international portfolio diversification, the introduction of sophisticated financial techniques for risk management, and the liberalization of market restrictions. Notably, the relaxation of restrictions on the private placement market in the United States introduced by the Security and Exchange Commission's Rule 144a has facilitated access by developing country borrowers to this market where information requirements are less rigorous than the stringent listing standards for public issues in industrial countries. 10/ Developing country access to the private placement market can help companies gain exposure to international institutional investors and pave the way for eventual public registration. Similar measures to remove restrictions on private placements should be considered in other countries, especially for investor groups that are

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9/ GAB refers to the Fund's General Arrangements to Borrow. Detailed information on the Basle Accord was provided to the Development Committee in Spring 1992. See the Annex to the "Implementation of the Debt Strategy--Progress Report" April 1992 (DC/92-7).

10/ Public registration in some industrial countries requires up to five years of financial data on the borrower, which may be difficult to compile in a country with a history of high inflation. Rule 144a serves to make private placements more attractive to investors by permitting qualified institutional buyers to trade privately placed securities immediately without waiting the stipulated two-year holding period that would otherwise apply.

relatively sophisticated and where access to off-shore markets is limited.

24. Recent steps to liberalize quality restrictions on international securities issues have also helped to facilitate access for developing countries. For example, in 1991 the Japanese authorities lowered the minimum credit rating for sovereign borrowers in the "Samurai" market, which has permitted continued access to this market for some developing countries. More generally, institutional investors are typically subject to regulatory guidance on holdings of foreign assets as well as sub-investment grade paper, while limits are placed in some countries on the sale to retail investors of paper issued on non-approved exchanges. Regulations governing institutional and retail investors should be reviewed to identify possible unnecessary impediments to developing country access. In reviewing such regulations, however, it is important to pay due regard to the protection of small investors and the maintenance of sound prudential standards.

25. FDI may also be facilitated by appropriate tax and regulatory policies in source countries. 11/ Bilateral investment treaties between host and source countries can help to ensure that tax policies do not distort investor decisions to unduly discourage FDI. A number of industrial countries provide incentives for outward FDI. While this has encouraged direct investment from these countries, it may also discriminate against host country investors and other foreign investors who do not have access to subsidies. Industrial countries have worked to develop general rules against subsidizing foreign investment as well as guidelines for foreign investors aimed at increasing the responsiveness of FDI to host country development objectives. 12/

V. ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS

26. International financial institutions (IFIs) encourage private investment flows to developing countries through the provision of policy advice and the financing of policy reforms in host countries; the financing of physical and social infrastructure; direct operations that deal with the private sector or catalyze private flows; technical assistance; and the dissemination of information.

11/ A detailed review of policy measures to facilitate foreign direct investment flows to developing countries was provided to the Development Committee in Spring 1991. See Section III of "The Role of Foreign Direct Investment in Development" (DC/91-5), April 1991.

12/ OECD, Declaration on International Investment and Multinational Enterprises, Paris, 1976.

27. Policy advice and financing from the IFIs help to provide support for stabilization and reform programs in host countries that establish an environment conducive to private capital flows. 13/ IMF support helps countries to implement macroeconomic adjustment and structural reforms aimed at achieving sustainable growth and external balance, without recourse to counter-productive trade or exchange restrictions, and typically contains provisions for further liberalization of these regimes. The World Bank and regional development banks provide financial sector adjustment loans to support the liberalization of financial markets and the development of local capital markets, while access to imported inputs and to export markets has been enhanced by Bank-supported trade reforms. Project lending by the World Bank and regional development banks has contributed directly to strengthening physical infrastructure and human resource development (for instance, in education and health) that improve productivity and cost efficiency. Where the overall policy framework is appropriate, both the Bank and Fund provide financing in support of commercial bank debt and debt service reduction operations.

28. Direct external financing of the private sector in developing countries by the IFIs is typically accomplished through private sector affiliates, such as the World Banks's IFC. Nearly half of the IFC's operations have been joint ventures between foreign and local partners, which has facilitated the transfer of technology and managerial and marketing know-how. The IFC is looking to increase its support in Africa--through, for example, the Africa Project Development Facility and the Africa Enterprise Fund--and in Eastern Europe. Like the IFC, the private sector affiliates of regional development banks undertake loan and equity investments in private enterprises in developing countries and facilitate and participate in foreign joint ventures. 14/

13/ Private sector development has become an increasing concern of IFIs' adjustment and investment operations. For example, typically two out of every three World Bank operations include specific components that support the private sector. A background paper entitled "Private Sector Development: A Progress Report" is being sent at the same time to the Development Committee.

14/ These affiliates include the Asian Finance and Investment Corporation (AFIC) founded in 1989 on the initiative of the Asian Development Bank (ADB), and the Inter-American Investment Corporation (IIC) established by the Inter-American Development Bank (IDB) in 1985. The ADB also directly undertakes nongovernment guaranteed loan and equity investments in private enterprises. The African Development Bank (AfDB), often in cooperation with other IFIs including the Islamic Development Bank (IsDB), has also provided support to African countries. The European Bank for Reconstruction and Development (EBRD) has no private

(continued...)

29. The World Bank has undertaken cofinancing with private investors through parallel financing arrangements, as well as export credit cofinancing, which is normally private commercial financing with insurance or guarantee coverage from export credit agencies of industrial countries. 15/ Under the expanded cofinancing operation (ECO) program, the Bank also has authorization to provide partial guarantees to catalyze private sector financing, although to date utilization of this program has been limited. The limited use of Bank guarantees under the ECO program may reflect in part the fact that this program has been in effect restricted to countries that have not restructured their debt in the previous five years, and that it has been targeted primarily at commercial banks precisely at a time when they were withdrawing from international investment.With expanded risk cover and more flexible operational guidelines introduced in 1992, 16/ ECO programs are expected to be more actively used. Particularly strong interest has been shown by governments and the market in arranging financing for large, limited recourse infrastructure projects. Looking ahead, the effectiveness of cofinancing and guarantees will depend on the degree to which they can be successfully applied to influence creditor perceptions of country risk in countries actively seeking to regain market access.

30. The IFC plays a particularly important role in mobilizing additional project funding from private investors and lenders, either in the form of cofinancing or through loan syndications. 17/ Private participation in infrastructure investments and operations has been encouraged by IFIs through innovative financing mechanisms that allow joint private consortia of domestic and foreign contractors (e.g., BOT agreements). The IFC's ability to catalyze commercial bank resources for projects in the developing world is enhanced in syndications where it is the lender of record (meaning that in effect the debtor country cannot differentiate between debt service payments to the IFC and to other participating commercial institutions). The IFC and private sector

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14/ (...continued)
sector affiliate but directly carries out equity investment and lending programs to promote the private sector in Eastern Europe and the FSU.

15/ Over the last five years, the cofinancing through parallel financing arrangements has averaged around US$1 billion per year and export credit cofinancing about US$2 billion per year.

16/ "Review of the Expanded Cofinancing Operations Program," World Bank, April 27, 1992 (R92-73).

17/ Loan syndications approved by the IFC reached a record US$1.4 billion for 39 projects in FY92.

affiliates of other IFIs have also undertaken underwriting activities that have brought private corporations to market.

31. Regional banks have also been active in cofinancing, particularly the ADB. Under its Complementary Financing Scheme, the ADB is the lender of record for commercial bank syndications which it prearranges in parallel with its own loans. Often such cofinancing is combined with a late-maturity guarantee. 18/ The scheme, which is comparable to IFC guarantees and syndications in the degree of comfort afforded to commercial lenders, has been successful in attracting new nonbank lenders (e.g., insurance companies) to participate.

32. Insurance of FDI against long-term noncommercial risk is offered by the Multilateral Investment Guarantee Agency (MIGA). Risks covered are currency transfer, expropriation, war and civil disturbance, and breach of contract. While activity under this program was initially limited, the number of guarantees issued increased to 21 in FY92 and 22 during the first nine months of FY93. The cumulative maximum contingent liability of MIGA under 56 outstanding guarantee contracts totalled US$760 million as of April 1, 1993. The total value of the projects in which MIGA's guarantee program has participated, alone or together with other insurers, is close to US$5 billion, mainly in Latin America, Europe and Asia.

33. Each of the IFIs has an extensive technical assistance program relevant for creating an economic setting conducive to private flows. The IMF and the World Bank provide assistance to promote transparent and non-distortionary tax systems, appropriate public expenditure priorities, regulatory reforms to reduce barriers to entry for private firms, and exchange system liberalization. Moreover, the IFIs have assisted banking system reform and capital market development, including to establish stock markets and to improve institutional structures and regulatory frameworks in a number of countries. Specialist technical advice has also been provided on debt restructuring, privatization, investment codes, and external debt management. The IFC has been particularly active in support of equity portfolio flows to developing countries: for instance, the IFC pioneered the introduction of country funds targeted at emerging stock markets. 19/ Finally, the World Bank has recently expanded its technical assistance programs in risk management involving the use of swaps, options, and futures contracts in several countries (e.g., Chile, Costa Rica, and Turkey) to improve developing countries' hedging capacity, including hedging by the private sector.

18/ The scheme has mobilized more than US$500 million for some 30 projects since its introduction in 1984.

19/ A total of around US$7.5 billion has been channeled to developing countries through such funds, mainly to Asia and Latin America.

34. The IFIs provide a wide range of promotional and advisory services. MIGA, for example, organizes investment promotion conferences and investment campaigns, bringing together foreign investors with host government officials and business executives for possible joint ventures. A number of training programs for business executives have also been conducted by MIGA and other IFIs. The Foreign Investment Advisory Service (FIAS)--a joint venture of IFC, MIGA and the Bank, specializing in FDI-related advisory functions--has been actively engaged in providing advice to host developing countries on policy and institutional changes necessary to overcome impediments to direct investment.

35. The efficient dissemination of information is important in reducing perceived risks inherent in foreign investment. The IFIs--most importantly the Bank and the Fund--publish extensive data and analytical reports, reviewing the latest developments in the economic and regulatory environment affecting international capital flows and are now working with developing countries toward improving the monitoring of portfolio flows to these countries. The IFC maintains an extensive database on emerging stock markets, providing timely price information and benchmark indexes to portfolio investors.

VI. PROSPECTS

36. The history of private capital flows to developing countries has included repeated episodes of surges in flows, followed by a market correction, debt servicing difficulties, and a curtailment of access. Market corrections have been triggered by a range of factors, including economic mismanagement, adverse movements in commodity prices, and a tightening of external financial conditions, and have usually involved a fundamental reappraisal of the risks involved in such financing. Accordingly, the issue arises of whether the recent access to private flows can be maintained and extended to countries that have yet to gain market access.

37. Based on recent experience, countries that already have access to a relatively broad investor base are likely to continue to attract private flows, provided that they continue to pursue sound policies. This expectation is supported by the fact that a number of Asian and European economies have maintained or even expanded market access over the last decade, notwithstanding shifts in external conditions and a curtailment of access of other developing countries. Moreover, the general trends in the international financial system that have facilitated flows to developing countries--including the globalization of markets and the diversification of investor portfolios--are likely to be irreversible.

38. For the recent market re-entrants, the investor base is still relatively narrow. To maintain the scale of flows to these countries, this base must be expanded. In this connection, the consolidation of economic and political stability is obviously critical, not least because it would lead to investment grade credit ratings that would facilitate access to institutional investors, which have represented a growing share of industrial country savings. In addition, the diversification of the investor base requires adequate protection against the risks of operating in a less sophisticated financial system, including through reforms to deepen local capital markets, to enhance financial regulation and supervision, and to bolster accounting and disclosure standards.

39. Prospects for private flows to developing countries with limited market access are divergent. Some may be able to attract significant private resources by sustaining progress toward creditworthiness and developing corporate and financial sectors with appropriate tax, regulatory, and legal frameworks. Moreover, for countries with heavy external indebtedness and significant arrears, debt restructuring operations and the normalization of creditor relations can be expected to improve the scope for access to international capital markets. International financial institutions have an important role to play to facilitate private capital flows to these countries, mainly through the provision of financial support (including for debt operations) and policy advice, as well as the diffusion of information about borrowing countries.

40. For many developing countries, however, the scope for private capital inflows is likely to remain tightly constrained. This would seem particularly so for low-income countries in Sub-Saharan Africa with poor resource endowments and locations remote from major markets as well as in regions of political instability. To date, medium- and long-term private financing for these countries has been mainly confined to enclave-type oil and mining projects. Moreover, for countries at a relatively low level of development, it will not be feasible to establish a fully fledged domestic capital market conducive to portfolio inflows quickly. More generally, many low-income countries will need to continue building up their physical and social infrastructure, supported by domestic savings and concessional external finance, before there will be realistic prospects of accessing private capital markets on a significant scale.

41. As an increasing range of countries has gained access to private capital inflows, it needs to be emphasized that even with improved economic performance and increasingly sophisticated markets, such flows (particularly portfolio flows) are potentially volatile. Integration into international capital markets brings benefits but also increases exposure to shifts in global financial conditions. Moreover,

domestic or international events may lead to shifts in investor sentiment, as occurred in the second half of 1992 in the wake of sharp declines in domestic stock markets and the turbulence in world foreign exchange markets in September. Thus, there should be sufficient resilience in the economic systems of host countries to ensure that shifts in investor sentiment can be met without loss of market access.

42. To cope with volatile flows, developing countries need to sustain appropriate macroeconomic and structural policies and be prepared to take additional adjustment measures as needed, supported where appropriate by Fund and World Bank advice and financial assistance. It will also be relevant for countries to pay attention to the structure and use of external financing and the balance between obligations falling due and potential variations in foreign exchange earnings. In this respect, excessive reliance on short-term financing should be avoided, while increasing the role of equity as opposed to debt financing enhances the flexibility of response to adverse events.In addition, there may be a role for the use of hedging techniques to reduce vulnerability to swings in external conditions.

43. As well as implying a possibly unstable build-up in external liabilities, heavy capital inflows may complicate economic management by threatening to undermine stabilization programs--either through excessive monetary growth or an exchange rate appreciation that may imply a loss of external competitiveness. 20/ Concerns about the destabilizing effect of inflows would be most acute where the inflows stemmed from reversible external developments or a tightening of domestic credit policies, rather than a fundamental improvement in the investment climate. In choosing among alternative policy responses, countries have faced difficult issues of finding an appropriate balance, especially given the uncertainties about the underlying causes and permanence of the inflows. The most flexible response to possible over-heating from transitory inflows may be a tightening of monetary policy to offset their effect. However, such a sterilization of inflows may be costly and eventually counter-productive, because the resulting higher domestic interest rates can fuel further capital inflows and intensify pressures on the exchange rate. Fiscal adjustment is likely to be more effective in restraining demand, although there would be practical limits on the ability of the government to fine-tune tax and spending policies in response to capital inflows, as well as trade-offs against long-term tax and spending objectives.

20/ For a more extensive discussion of these issues, see the forthcoming Fund staff paper on "Recent Experience with Surges in Capital Inflows."

44. In a number of countries, the authorities have adopted more direct means to slow capital inflows, including setting minimum quality restrictions on issuers, introducing queuing systems, tightening prudential standards on banking activity, setting reserve requirements on foreign borrowing, and imposing withholding taxes. However, these steps can impose costs by distorting economic decisions. Moreover, given the incentives for evasion, it is questionable whether such controls can be effective for long in a relatively open economy. In any event, in countries where there has been a long-term improvement in the efficiency of the traded goods sector of the economy and access to international capital markets has been regained on a durable basis, the attempt to suppress a movement in the real exchange rate may not be sustainable. In this situation, a real appreciation of the exchange rate may be an equilibrating response.

Table 1. International Bond Issues by Developing Countries[1/]

(In millions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Developing countries	3,676	6,418	4,470	5,994	12,260	22,938
Africa	49	471	159	90	236	725
Algeria	49	433	159	90	—	—
South Africa	—	38	—	—	236	725
Asia	2,411	2,632	1,308	1,459	3,337	5,686
China	1,415	912	—	—	115	1,359
India	377	715	450	274	227	—
Indonesia	50	221	175	80	369	494
Korea	332	130	258	1,105	2,609	3,177
Malaysia	216	361	425	—	—	—
Nauru	—	32	—	—	—	—
Pakistan	21	—	—	—	—	—
Thailand	—	261	—	—	17	656
Europe	866	2,438	2,170	1,856	1,960	4,562
Bulgaria	—	—	101	—	—	—
Former Czechoslovakia	—	130	—	375	277	129
Former Soviet Union	—	333	—	—	—	—
Hungary	555	816	879	888	1,186	1,242
Turkey	311	1,159	1,190	593	497	3,191
Western Hemisphere	350	877	833	2,589	6,727	11,965
Argentina	195	—	—	21	795	1,570
Barbados	—	40	—	—	—	—
Brazil	—	—	—	—	1,731	3,415
Chile	—	—	—	—	200	—
Colombia	50	—	—	—	—	—
Mexico	—	—	570	2,306	3,373	5,848
Panama	—	—	—	—	50	—
Trinidad & Tobago	105	79	—	—	—	100
Uruguay	—	—	—	—	—	100
Venezuela	—	758	263	262	578	932
Memorandum items:						
Global issues in international bond markets	177,292	227,143	252,132	226,059	301,342	343,617
Share of developing countries in global issuance	2.1%	2.8%	1.8%	2.6%	4.1%	6.7%

Sources: IMF and World Bank staff estimates based on reports in Euromoney Bondware; Euroweek; Financial Statistics Monthly; Financial Times; International Financing Review; and OECD.

1/ *Including note issues under EMTN programs. Figures for 1987 and 1988 are based on OECD data and are not strictly comparable to those for 1989-92, owing to different coverage.*

Table 2. International Equity Issues by Developing Country Companies [1] [2]

(In millions of U.S. dollars)

	1990	1991	1992
Developing countries	1,047	5,037	7,256
Africa	--	143	270
South Africa	--	143	270
Asia	825	683	2,708
China	--	11	1,049
India	--	--	240
Indonesia	633	168	262
Korea	40	200	150
Malaysia	--	--	382
Pakistan	--	11	48
Philippines	53	99	432
Thailand	99	194	145
Europe	124	91	67
Hungary	68	91	33
Turkey	56	--	34
Western Hemisphere	98	4,120	4,211
Argentina	--	356	504
Brazil	--	--	150
Chile	98	--	129
Mexico	--	3,764	3,058
Panama	--	--	88
Venezuela	--	--	282
Global issues in international equity markets	8,152	15,546	22,632
Share of developing countries in global issuance	12.8%	32.4%	32.1%

Sources: IMF and World Bank staff estimates based on reports in Euromoney Bondware; Euroweek; Financial Times; IFC; International Financing Review; and Lipper Analytical Services.

[1] *Includes depository receipts and China "B-shares." Excludes direct equity purchases by foreign investors in local stock markets, including by new country funds.*

[2] *New country or regional funds for developing country stock markets are estimated to have reached: US$607 million in 1986; US$761 million in 1987; US$1,095 million in 1988; US$2,199 in 1989; US$2,867 million in 1990; US$1,273 million in 1991; and US$2,164 million in 1992.*

Table 3. Net Foreign Direct Investment Flows to Developing Countries [1]

(In billions of U.S. dollars)

	1987	1988	1989	1990	1991	Estimate 1992
Developing countries	10.0	18.2	19.6	20.9	28.6	36.8
Africa	1.0	1.3	3.3	1.5	1.4	1.7
Algeria	-0.1	--	--	--	-0.1	--
Botswana	-0.1	0.2	0.1	0.2	0.1	0.1
Cameroon	--	--	--	--	--	0.1
Gabon	0.3	0.2	--	-0.1	-0.2	-0.1
Morocco	0.1	0.1	0.2	0.2	0.4	0.6
Nigeria	0.6	0.4	2.4	0.6	0.6	0.5
Senegal	0.1	0.1	0.1	0.1	0.1	0.1
Tunisia	0.1	0.1	0.1	0.2	0.2	0.2
Other	--	0.2	0.2	0.3	0.3	0.2
Asia	4.7	7.3	8.6	9.8	11.2	14.3
China	1.7	2.3	2.6	2.7	3.7	5.6
India	0.2	0.3	0.3	0.4	0.2	0.4
Indonesia	0.5	0.6	0.7	1.2	1.5	1.7
Korea	0.4	0.7	0.5	-0.1	-0.2	-0.3
Malaysia	1.0	1.1	1.8	3.0	3.0	3.6
Pakistan	0.1	0.2	0.2	0.3	0.5	0.7
Papua New Guinea	0.1	0.1	0.2	0.1	0.2	0.2
Philippines	0.3	1.0	0.8	0.5	0.7	1.0
Sri Lanka	0.1	--	--	--	--	--
Thailand	0.2	0.9	1.4	1.6	1.2	1.0
Other	0.1	0.1	--	0.3	0.4	0.2
Europe	-0.9	1.4	-0.2	0.7	2.9	4.4
Former Czechoslovakia	--	--	0.3	0.2	0.6	1.1
Hungary	--	--	0.2	0.3	1.5	1.4
Poland	--	--	--	--	0.1	0.3
Romania	--	--	--	--	--	0.1
Former Soviet Union	-1.0	1.0	-1.3	-0.7	-0.2	0.3
Turkey	0.1	0.4	0.7	0.7	0.8	1.1
Former Yugoslavia	--	--	--	0.2	0.1	0.1
Latin America	4.0	6.8	6.2	7.2	11.7	14.5
Argentina	--	1.1	1.0	2.0	2.4	2.4
Brazil	1.1	2.9	0.7	0.3	0.6	3.0
Chile	0.1	0.1	0.3	0.6	0.5	0.5
Colombia	0.3	0.2	0.5	0.5	0.4	0.6
Costa Rica	0.1	0.1	0.1	0.1	0.1	0.1
Dominican Republic	0.1	0.1	0.1	0.1	0.1	0.2
Ecuador	0.1	0.1	0.1	0.1	0.1	0.1
Guatemala	0.1	0.1	0.1	0.1	0.1	0.1
Jamaica	0.1	--	0.1	0.1	--	--
Mexico	1.8	1.7	2.6	2.5	4.8	6.0
Panama	--	--	--	--	0.1	--
Trinidad & Tobago	0.1	--	0.1	0.1	0.1	0.2
Venezuela	--	0.1	0.2	0.5	1.9	0.7
Other	0.2	0.3	0.3	0.3	0.4	0.6
Middle East	1.3	1.4	1.6	1.7	1.5	1.8
Egypt	1.1	1.1	1.2	0.7	0.4	0.3
Oman	--	0.1	0.1	0.2	0.2	0.2
Saudi Arabia	--	--	--	0.1	0.1	0.2
Yemen Arab Republic	--	-0.3	-0.4	--	--	--
Other	0.1	0.5	0.7	0.7	0.8	1.1

Source: IMF WEO data base (February 1993 update).

[1] *Net of FDI abroad. For some middle-income countries (e.g., Korea and Saudi Arabia), small or negative numbers reflect significant outward FDI flows.*

Table 4. Bank Credit Commitments to Developing Countries

(In billions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Developing countries [1]	25.1	19.5	16.7	21.0	20.8	16.2
Africa	0.7	0.5	0.5	0.6	0.2	0.6
Algeria	0.4	0.4	0.2	--	0.1	--
Angola	--	--	--	--	--	0.3
Côte d'Ivoire	--	--	--	--	--	--
Ghana	--	--	--	0.1	0.1	0.1
Morocco	--	0.1	--	0.1	--	--
Nigeria	--	--	--	--	--	--
South Africa	--	--	--	--	--	--
Tunisia	--	--	--	--	--	0.1
Zimbabwe	--	--	0.1	--	0.1	--
Other	0.3	--	0.2	0.4	--	0.1
Asia	8.5	7.8	8.2	12.0	12.9	9.7
China	3.3	2.7	1.6	1.5	2.3	2.7
India	1.8	1.6	1.4	0.7	--	0.2
Indonesia	1.6	0.5	2.3	3.9	5.0	1.8
Korea	0.9	1.2	0.7	2.0	3.5	1.8
Malaysia	0.3	0.8	0.1	0.5	0.2	1.2
Pakistan	0.1	0.1	0.4	0.4	0.1	--
Papua New Guinea	--	--	--	0.1	0.3	--
Philippines	--	--	--	0.7	--	--
Thailand	0.3	0.8	0.8	1.3	1.6	2.0
Viet Nam	--	--	--	--	--	--
Other	0.1	0.1	0.2	0.1	--	--
Europe	5.4	4.4	4.1	4.9	1.9	2.1
Bulgaria	0.3	0.1	0.3	--	--	--
Former Czechoslovakia	0.2	0.2	0.3	--	--	--
Hungary	1.4	0.2	0.8	--	0.1	0.2
Turkey	2.6	1.7	1.7	1.8	1.6	1.8
Former U.S.S.R.	0.8	2.2	0.9	3.0	--	--
Other	0.1	--	0.1	0.1	0.2	0.1
Middle East	0.3	0.3	2.0	0.2	4.8	2.9
Egypt	--	--	0.5	--	--	--
Jordan	0.2	0.2	--	--	--	--
Saudi Arabia	--	--	0.7	0.1	4.5	2.9
Other	0.1	--	0.7	0.1	0.3	--
Western Hemisphere	10.1	6.5	1.9	3.3	1.0	0.9
Argentina	2.1	--	--	--	--	--
Brazil	--	5.2	0.1	--	--	0.2
Chile	--	0.2	--	0.3	--	0.4
Colombia	0.1	1.0	1.6	--	0.2	--
Mexico	7.7	--	0.2	1.6	0.6	0.2
Uruguay	--	--	--	--	0.1	--
Venezuela	--	0.1	--	1.4	--	0.2
Other	0.2	--	--	--	0.1	--
Memorandum items:						
Offshore banking centers	0.3	0.4	3.5	3.7	1.5	1.6
Total international bank credit commitments	91.4	125.6	121.1	124.5	116.0	117.9
Share of developing countries in total	27%	16%	14%	17%	18%	14%

Sources: Organization for Economic Cooperation and Development, Financial Statistics Monthly.

[1] *Excludes offshore banking centers.*

EXECUTIVE SUMMARY

(i) Governments tilted increasingly toward competitive-market economic policies during the period under review. Private investment in a sample of developing countries climbed to 13 percent of GDP in 1991, near the peak of the late 1970s. However, the persistent absence of a private investment response in some low-income countries undergoing adjustment suggested that relative price reform and macroeconomic stabilization are not sufficient conditions for restoring efficient private sector growth.

(ii) The World Bank Group's (WBG's) strategy for supporting private sector development (PSD) reflects a move toward a "second generation" of PSD efforts which integrate institutional changes with policy reforms. The approach aims to help countries overcome legal and institutional obstacles affecting the business environment and relax constraints to firms at the day-to-day operating level. It also confronts new challenges in areas such as privatization and financial sector reform. The WBG's PSD strategy has three themes: (i) **improving the business environment** involves support for procedural, regulatory and legal reforms; (ii) **public sector restructuring** involves reorienting public spending to achieve more efficient use of private and public resources; (iii) **financial sector development** involves support for the development of efficient financial systems that mobilize savings and channel them to the most productive end uses.

IMPROVING THE BUSINESS ENVIRONMENT

(iii) Progress was made in helping policy makers understand and address key constraints affecting private firms. Private Sector Assessments (PSAs), which help the WBG and client governments gain a clearer view of the business environment, were initiated jointly by the World Bank and the IFC in 19 countries.

(iv) The next step, to build an environment supportive of PSD, will be long and difficult. In Eastern Europe and the former Soviet Union (FSU), for example, the challenge is to create a modern private sector virtually from scratch. Technical assistance provided to some nations of the FSU laid the basis for upcoming WBG operations dealing with the business environment, as well as privatization and financial sector development.

PUBLIC SECTOR RESTRUCTURING

(v) Upgrading Public Administration Capacity. Work in this area increasingly reflects recognition that trimming public sectors

through privatization must be complemented with enhanced capacity in public agencies that are critical to development. To better meet the needs of a market economy, governments, with WBG support, are upgrading administrative functions in areas such as the tax and judicial systems, investment promotion and public procurement. Evidence from high-performing economies also points to a critical role for public promotion of an educated, healthy and trained workforce.

(vi) Privatization is another area where, as experience with privatization has deepened, a second generation of program design issues has come to the fore: the importance of transparency, of dealing with the potential direct social costs of privatization, and of establishing a post-privatization environment which stimulates competition, promotes equity and inhibits economic concentration. Between January 1991 and June 30, 1992, the World Bank approved 59 investment operations and 42 adjustment operations with components addressing privatization or restructuring of public enterprises. The IFC, which has made privatization a central and expanding element of its investment program, undertook 11 privatization transactions in FY92. It also devoted substantial resources to privatization advisory work in Russia, Eastern Europe, and in other regions.

(vii) Private Provision of Infrastructure. Governments, particularly in Latin America and Asia, are increasingly allowing and encouraging private operators to provide infrastructure services normally handled by public agencies. Leveraging of WBG support to attract private resources for infrastructure is an area of increasing demand from client countries, and where innovative approaches are being attempted. Success can be difficult because of the lumpiness of most infrastructure investments, and the deterrent effect on prospective investors of country risks, and regulatory constraints and uncertainties. But the potential payoff is great in terms of increasing the pool of resources available for basic infrastructure.

FINANCIAL SECTOR REFORM

(viii) Increasing effort is being devoted to a second generation of reforms in this area as well. Appropriate legal, regulatory and supervisory structures for the financial sector, including prudential regulation, are vital to ensure a sound financial system. Recent work has focused on achieving a balance between, on the one hand, promoting competition to ensure efficiency, and, on the other hand, avoiding excessive competition that can undermine the stability of the banking system. The WBG's operational approach in support of financial intermediaries has been revised, with greater emphasis now put on (a) the need for sector policy reform to be combined with macroeconomic reform and (b) improvements in financial infrastructure and strengthening of specific financial institutions.

CONCLUSION

(ix) While there have been considerable advances in PSD in 1991/92, challenges remain. In a number of developing countries private investment response remains sluggish -- in many cases despite intensive adjustment efforts. In Central and Eastern Europe, the process of privatization, the sine qua non for the transformation from command to market-based economies, is moving more slowly than anticipated as the authorities come to grips with the complexities of transferring ownership in the context of economic transition.

(x) Institutional strengthening, and the development of an institutional culture supportive of PSD, are long and difficult processes, highly susceptible to failure and heavily dependent on unwavering government commitment. The WBG has made progress in this area as it continues to learn from experience. Indeed, the Bank Group finds itself continually confronting unforeseen problems and complexities in PSD.

(xi) The WBG must help accelerate the process that has led from "first generation" adjustment measures -- which focus on creating a stable macroeconomic framework and an efficient price regime -- to "second generation" measures aimed directly at improving the day-to-day environment in which firms operate. In doing so, it must look for new ways to (i) understand the dynamics of the environment affecting PSD; (ii) forge linkages between the various local institutions critical to PSD; (iii) learn from successful country experiences in implementing PSD reforms. The World Bank's newly established Vice Presidency for Finance and Private Sector Development, working in collaboration with World Bank operational units and CFS, as well as the IFC, MIGA, and FIAS will be giving a high priority to these issues.

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(Prepared by World Bank staff)

A. Trends in Private Sector Development

1. The climate for private sector development (PSD) warmed considerably during the period under review as governments tilted increasingly toward competitive-market solutions to boost economic growth, generate employment and redistribute wealth. Dramatic events in the former socialist economies, which accelerated their efforts to move towards market-based economies, influenced a fundamental shift in the way many countries viewed their options for economic development. As state-owned assets in the transition economies of Eastern Europe and the former Soviet Union were transferred to private hands, and as legal, regulatory and financial reforms began to take hold, enterprises by the thousands entered the economic mainstream. For example, the number of formally registered small private businesses in Romania reached 195,000 by September 1991, two years after private entrepreneurship was legalized, and then doubled by the end of 1992 to 386,000. In Poland, in the wake of a sweeping reform program, 1991 saw the number of private enterprises grow to 1.5 million from 1.2 million the previous year, an increase of 25 percent, while the Polish private sector's share of industrial production expanded from 17 percent to an estimated 24 percent of GDP. Latin America too continued to make important progress in privatization and in other areas related to creating a more favorable environment for the private sector. This progress was reflected in increased inflows of private investment to the region.

2. Overall, private investment in a sample of 47 developing countries reached an average of 13 percent of GDP in 1991, up from 12 percent the previous year and from the trough of 10 percent recorded in 1985 and 1986.[1/] Private investment levels are now approaching their peak of the late 1970s, and in a number of larger developing countries have surpassed this peak.

3. Foreign direct investment (FDI) -- a resource which entails important benefits related to technology transfer, management know-how and access to export markets -- has also shown a positive trend. Although global flows of FDI declined since 1989, flows to developing countries increased by over 75 percent between 1990 and 1992, reflecting improved macroeconomic performance (particularly in some Latin American countries, following debt reduction

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1/ *Guy P. Pfeffermann and Andrea Madarassy, Trends in Private Investment in Developing Countries 1993, IFC Discussion Paper 16. Washington: The World Bank, 1992.*

agreements), more welcoming regulatory regimes (e.g. in Thailand) and active privatization and debt reduction programs.[2]

B. The Challenge of Private Sector Development

4. The generally positive global trends disguise regional disparities. In Sub-Saharan Africa and South Asia, private investment remained at low levels, at or below 10 percent of GDP (compared with 22 percent for East Asia and 12 percent for Latin America). These trends, juxtaposed against a growing body of operational experience, research and analytical work in PSD, suggest that private sector supply response is conditioned by an interplay of macroeconomic stabilization and reform on the one hand, and a series of institutional factors that shape the day-to-day business environment on the other hand. Indeed, the persistent absence of a pronounced investment response in a number of low-income countries undergoing adjustment programs suggests that relative price reform and macroeconomic stabilization are not sufficient conditions for restoring (or launching) efficient private sector growth. Although attention to prices and stabilization must normally be given highest priority in a reform program, work in these areas must be followed by complementary measures to address other important constraints to PSD such as weak and poorly administered legal and regulatory systems, poorly functioning institutions and markets, inadequate physical infrastructure and a weak human capital base. A similar picture is emerging in terms of creating an environment attractive to FDI: macroeconomic issues, such as a liberal foreign exchange regime, matter, but so do institutional issues such as a transparent and non-discriminatory legal and regulatory framework and a stable and predictable administrative and commercial environment.[3]

C. Responding to the Challenge: The World Bank Group's PSD Strategy

5. The World Bank Group's (WBG's) support for private sector development as a means to alleviate poverty and promote growth has substantially evolved since its inception. Early project lending often focused on creating the infrastructural base to complement industrial and agricultural development. Adjustment lending of the 1980s expanded this focus by working to establish a macroeconomic

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[2] Global Economic Prospects and the Developing Countries, 1993. *Washington: The World Bank, International Economics Department, 1993. Draft.*

[3] *The issue of foreign direct investment is discussed fully in the World Bank-IMF Issues Paper, entitled "Developing Country Access to Private Capital Flows," which is being presented concurrently to the Development Committee.*

framework for PSD of stability and appropriate relative prices. During the 1980s, the Bank moved increasingly to target its interventions on specific obstacles to PSD while continuing to stress the need for adequate infrastructure and supportive policies. As adjustment efforts continued into the 1990s, the WBG's strategy for promoting PSD reflected the earlier experience, placing emphasis on what might be called a second generation of PSD efforts. The new strategy has become more focused on an integrated set of policy reforms, derived from a careful understanding of the day--to-day operating constraints confronted by entrepreneurs. The strategy emphasizes the need to attend to PSD problems beyond the provision of macroeconomic stability. In addition, it confronts new challenges such as the design of privatization programs to mitigate their social costs and ensure the transparency of transactions, and support for new areas of private sector involvement such as the financing and provision of infrastructure. Formally adopted in 1989, the WBG's "Private Sector Development Action Program," has three principal themes:

- Improving the Business Environment
- Public Sector Restructuring
- Financial Sector Development

6. The strategy has been fully discussed in previous documents prepared for the Development Committee and the Board[4/], and will only be reviewed briefly here:

7. **Improving the Business Environment.** The WBG supports policy, regulatory and legal reforms directed at improving the environment for PSD. Work may focus on, among other things, removing barriers to entry and exit, changing labor laws to reduce rigidities in labor markets, simplifying and improving the tax system to make it more transparent and less distortionary, streamlining systems for establishing property rights, rationalizing procedures for the licensing and registration of businesses, or removing or modifying trade restrictions that stifle business activity. The WBG also works with countries to reform

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[4/] (1) *Private Sector Development Action Program, January 11, 1989 (R89-9); (2) Progress Report on the Private Sector Development Action Program, March 13, 1990; (3) The Contribution of the Private Sector to Development and the Roles of the Bank Group and the Fund, March 15, 1990 (SecM90-321); (4) Review of the Implementation of the Bank's Action Plan for Private Sector Development and Progress in the Discussion of the IFC's Capital Adequacy, August 2, 1990 (SecM90-1032); (5) Private Sector Development: Strengthening the Bank Group Effort, April 26, 1991 (R91-79); (6) Strengthening the World Bank Group Effort on Private Sector Development -- A Supplemental Paper, June 10, 1991 (R91-139).*

features of their business environment which may create barriers to potential foreign investors.

8. **Public Sector Restructuring.** The WBG is helping governments reassess public spending priorities and prune unmanageable or peripheral activities, thereby allowing for a more efficient use of both public and private skills and resources. This may mean shrinking the direct involvement of the state in the economy through divestiture or liquidation of state-owned enterprises. It may also mean enhancing government regulatory capacity, and strengthening procurement and contracting functions so that the state can use the private sector in traditional public sector functions such as infrastructure and social service provision. An important related goal is to strengthen the role of the state by working to build capacity in public institutions that play a key role in PSD.

9. **Financial Sector Reform.** The WBG supports the development of efficient financial systems that mobilize savings and channel them to their most productive end uses. Work has focused both on policy reform, e.g. deregulation of interest rates, and on addressing rigidities and inadequacies within financial sector institutions. A second generation of operations integrates institutional reform with a concern for the policy environment in which it takes place, emphasizing such factors as prudential regulation and bank supervision. The IFC is actively involved in addressing the scarcity of equity capital in many developing countries by promoting the development of capital markets through advice, investments, and the introduction of new financial institutions and instruments.

10. The WBG has also undertaken internal organizational changes in order to better equip itself to respond to the challenges of PSD. These developments are summarized in Box 1. IFC and Bank

Box 1
World Bank Group Organizational Changes to Support PSD

1. The World Bank. A new Vice Presidency for Finance and Private

staff will continue to work together on key issues facing the private sector. The recent reorganization in the Bank and the creation of a Central Vice Presidency ensures a more focused approach to the broad policy issues in this area and provides an improved framework for intellectual leadership and dissemination of best practices. At the country level the IFC will continue to play its leading role in specific transactions across the broad range of its capacities. It will also more actively participate in Bank country assistance strategy discussions so that its policy and institutional concerns are better addressed and to minimize

duplication of efforts. The Bank's comparative advantage will remain at the policy level. However, there will be instances where direct project cooperation or work on a specific policy issue will make sense and be pursued.

D. Progress in Promoting Private Sector Development

11. This section reviews progress made in the WBG's client countries in promoting PSD over a period extending from, approximately, January 1, 1991 through December 30, 1992. The discussion will highlight the WBG's involvement, but broader developments at the country level will also be cited. Annex 1 provides statistical data on the World Bank's PSD activity via adjustment and investment lending.

(i) Improving the Business Environment

12. The business environment is shaped by a complex interaction of formal policies and laws, informal practices, institutions and infrastructure. The critical challenge facing policy makers in setting priorities for improving the business environment is to distinguish real from apparent obstacles, and gain a clear view of binding constraints that actually affect entrepreneurs. To this end, the WBG has made gains over the past two years. Private Sector Assessments (PSAs), which analyze the structure of, and constraints to, the private sector in given countries, and which lay out steps to advance PSD, have provided a sharper focus for analytical work at the country level. Collaborative efforts of the World Bank and the IFC, with inputs from MIGA and FIAS, PSAs have so far been initiated in 19 countries.[5] Many PSAs include in-depth interviews with entrepreneurs and firm-level surveys, which have provided insights into how entrepreneurs themselves -- including small operators who normally lack a voice in the policy process -- see the day-to-day world in which they operate. This input complements information gathered from more traditional sources (see Box 2).

13. The private sector's response to business environment reforms is often complex and may be difficult to gauge over the short term. A key variable is business confidence,[6] a factor which can be influenced by discrete interventions, but which

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[5] *Four PSAs have been completed to date, and a further nine are expected to be finished by the end of FY93. An additional 10 PSAs are currently expected to be completed in FY94.*

[6] *Luis Serven and Andrés Solimano, Private Investment and Macroeconomic Adjustment: A Survey, World Bank Research Observer, Vol. 7, No. 1.*

Box 2
Direct from the Source: Insights from Entrepreneurs

Private Sector Assessments (PSAs) use direct consultation with entrepreneurs through interviews and firm-level surveys to break through the limitations of official contacts and formal information sources. Recent PSAs and related studies have yielded findings with valuable strategic implications:

- The Zimbabwean PSA identified limited access to land and credit, inadequate skills and infrastructure, and government policies favoring large industry as constraints of special importance to small and medium firms.

- The Poland PSA described how the financial requirements of some 2,000 poorly-performing industrial state-owned enterprises are crowding out the emerging private industrial sector from access to commercial bank credit. It also found that property owners , as in many emerging market economies, are constrained by inadequate legal and conflict-resolution mechanisms for protecting ownership rights.

- In Kenya, a firm survey revealed that complex and discretionary licensing requirements imposed stiff costs on private firms. The average firm requires 15 licenses per year and 223 staff hours to obtain them. Substantial illegal charges for registration and licenses add 66 percent to official fees; and total costs, including official and irregular charges, amount to the equivalent of a regressively-structured 22 percent tax on incremental profits.

- The Uruguay PSA's enterprise survey found that exporters were heavily burdened -- compared to enterprises generally -- by permits and business licenses. Exporters in Uruguay require nearly seven times as many permits as other firms, bear far greater annual costs, and devote 38 percent more time to regulatory compliance.

ultimately is a long-term result of political stability and policy consistency. In Latin America, for example, preliminary results from PSAs suggest that when rules change, potential new investors first try to ascertain how permanent is the new business environment, a degree of caution understandable in a region that lacks a tradition of political and economic stability. A sustained period of consistent government actions aimed at creating a "market- friendly" business environment is required to build sufficient confidence among private investors.

14. The depth and breadth of the effort required to create a business environment supportive of PSD is evident in Sub-Saharan Africa, where only recently have many governments moved from

controlling private entrepreneurship to promoting it as an engine of growth, and where institutions and infrastructure important to PSD are often critically weak. The WBG has provided support to this necessarily long and difficult process of building up institutional capacity. Between January 1991 and June of 1992, the World Bank undertook 42 projects to improve the business environment in 24 countries of Sub-Saharan Africa. A case in point is Mali, where, in the period 1968-88, the only really successful firms were small and in areas of minimal interest to the public sector (e.g. bakeries and restaurants) or in the informal sector. Prior to the late 1980s, the Malian government treated the private sector with suspicion, tightly regulating most prices and requiring that workers be recruited through the government's employment office. Bank credit went mainly to the public enterprise sector, leaving little for most private enterprises. Business services were virtually unavailable. A recently approved World Bank project supports the government's program to create a comprehensive framework to support PSD, ranging from regulatory and policy reform to infrastructure to financial intermediation.

15. The countries of South Asia are also taking substantial strides towards improving the environment for private enterprise, with Bank Group support. Between January of 1991 and June of 1992, 14 projects containing business environment components were launched in four of the seven South Asian nations where the World Bank is active. India is rapidly replacing its policies of public sector expansion and intervention in markets with budget restraint, trade and investment policy reform, and the systematic reduction of administrative controls over firms' entry, expansion and diversification.

16. The countries of Eastern Europe and the former Soviet Union (FSU) present the extremely difficult challenge of creating a modern private sector virtually from scratch. In Russia, fundamental business environment features taken for granted in modern market economies and even in many developing countries simply do not exist. A stable and known set of rules governing central issues such as investment, taxation and land ownership is only beginning to emerge, while the underlying legal framework is an anachronism, unsuited to the needs of a market economy. Nor is there an institutional heritage or an administrative "culture" geared to creating and maintaining a legal and regulatory environment supportive of PSD. Issues related to property rights provide but one example of the types of obstacles to be overcome. A survey of Russian private firms identified limited access to business premises as one of the most important constraints facing enterprises. Russia has no functioning commercial real estate market; desirable properties are typically controlled by local authorities and state-owned enterprises. Even when leases on land are secured, tenants have no assurance that they will be honored because most jurisdictions lack a centralized register of title. A second major constraint emerging from the firm survey, further

reflecting the general climate of uncertainty in which firms are operating, was a lack of basic information related to business start-up and operations, such as facts on regulations as well as on input and output markets.

17. The obstacles affecting PSD in these economies are deep-seated and not susceptible to "quick fixes." Progress will be slow, but important first steps have been taken. Support for economic transition in some of the nations of the FSU was provided under the 1991 Technical Cooperation Agreement, which created a technical assistance trust fund executed by the WBG.[7] Work financed from the trust fund laid the basis for dialogue with FSU governments and for operations dealing with the business environment (as well as privatization and financial sector development). A component of the World Bank's privatization project in Russia will support the provision of business services to small enterprises.

(ii) Public Sector Restructuring and Privatization

18. Promotion of PSD through public sector restructuring has tended to focus on trimming overextended public sectors. The emergence, especially since the early 1970s of bloated, inefficient public agencies in many developing countries discouraged private investment and had a negative effect on economic growth. The reaction to this trend, in the wake of the debt crisis of the early 1980s, was typically to support measures such as privatization of state-owned enterprises and private-sector delivery of public services. But more recently the balance has been shifting to a view that restructuring the public sector through privatization is not a sufficient strategy for supporting PSD[8]. Rather, privatization must be complemented by emphasis on refocusing and upgrading public administrative capacities which have the potential to profoundly affect the growth and efficiency of the private sector, in areas such as tax and customs administration, regulation, trade and investment promotion, enterprise support services, court administration and infrastructure planning and provision. Moreover, evidence from high-performing economies points to the critical role of public promotion of an educated, trained and healthy workforce, and of an environment conducive to learning and the spread of innovative ideas and technologies. To

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7/ *Work under the Technical Cooperation Agreement was carried out in Russia, Kazahkstan, Kyrghyzstan and Belarus.*

8/ *Nor is it always a necessary strategy. Countries such as China and South Korea, for example, have dramatically increased the relative share of the private sector in the economy without privatization by encouraging rapid private sector growth.*

an important extent, renewed interest in the role of the state in PSD has been sparked by the outstanding performance of a number of the East Asian economies, where governments have been active in managing and promoting PSD.[9]

19. **Upgrading Public Administration Capacity.** A number of governments, in order to better meet the needs of a market economy, are focusing on reforming core functions of public administration in areas such as the tax and judicial systems. In Bangladesh, for example, courts used to take up to 15 years to process suits brought by financial institutions against defaulting borrowers. With assistance from the WBG, Bangladesh enacted legislation establishing special commercial courts to handle expeditiously actions brought by financial institutions against defaulting borrowers. Similarly, in Côte d'Ivoire, reforms are underway to speed up judicial decision-making and ensure rapid execution of judgements. Confusion and inefficiency arising from tax administration often surface in firm surveys as significant obstacles to entrepreneurs.[10] In Argentina, where modifications to tax codes occurred with bewildering frequency, firms found it difficult to keep up to date with their obligations. Well over 300 laws, decrees or resolutions affecting tax administration were passed in Argentina between 1986 and 1990. Recently, a process of reform was begun to simplify the legal framework for tax administration. The Argentine government's tax administration project, supported by the WBG, includes a component to continue this work, as well as to upgrade taxpayer services in areas such as information on tax obligations, improved service in local offices, and direct access by taxpayers to their account data.

20. Governments are also working on strengthening the capacity of public agencies that provide direct services to the private sector. In the Philippines, for example, the Board of Investments has responsibility for promoting foreign direct (as well as domestic) investment, but its corporate culture has led it to focus on regulatory and control functions. FIAS provided the government with an action plan for institutional and policy changes designed to shift BOI's focus from regulation towards promotion of investment. The government has indicated that it plans to incorporate the recommendations in a restructuring of BOI. Public procurement is another key facet of direct public/private sector interaction. Because government is a potentially huge customer for

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[9] *The World Bank is now completing a major study of the East Asian high-growth economies which will evaluate the extent to which their rate and pattern of growth is attributable to public policy, and the degree to which East Asia's successes may be replicable elsewhere.*

[10] *This is to be distinguished from tax levels, which, not unexpectedly, are also a common source of complaint.*

the private sector, the quality of public procurement administration can have an important impact on private sector profitability. But the procurement process is often tainted by rent-seeking, lack of transparency and procedural incompetence. In one country where the World Bank recently conducted a Private Sector Assessment, it was found to be common practice for government agents to demand that firms make illegal front-end payments of 10 to 20 percent of the projected contract value in order to secure government business. Firms must therefore allocate significant resources to such payments and to cultivating public officials. Many developing country governments have reformed procurement practices to eliminate rent-seeking and promote transparency. Often, however, there is a need to take the additional step of ensuring that public agencies responsible for procurement have the capacity and incentive to apply the new rules. To this end, the WBG is supporting efforts in Burkina Faso to train procurement staff and develop management systems to control illegal and negligent practices.

21. Making the public sector better able to respond to the needs of the private sector also involves building a framework for collaboration between the public and private sectors. This was the rationale behind the Ghanaian government's decision to establish, in the context of a World Bank adjustment operation, an advisory group consisting of public and private sector representatives. This innovative arrangement is described in Box 3.

22. **Working With NGOs.** Any discussion of the "private sector" must of course include references to organizations commonly known as non-governmental organizations, or NGOs, which operate in the not-for-profit private sector. Increased interaction between NGOs and the public sector is an important trend in the evolving relationship between the public and private sectors. Relations between developing country governments and NGOs have long been characterized by mutual distrust. Governments in countries with a history of political instability have often seen NGOs as havens for political resistance; NGOs, in turn, have feared that involvement with government would compromise their independence. But these attitudes have softened as governments have come increasingly to appreciate the capacity of NGOs to complement or substitute provision of services traditionally provided by public agencies. The WBG has been systematically strengthening its efforts to expand NGO involvement in operations that it finances. Particular attention is paid to encouraging greater involvement of locally-based NGOs. Approximately one third of World Bank projects approved in FY92 involved NGOs, most notably in projects related to agriculture and rural development, and the population, health and nutrition sectors. The World Bank is also making progress in involving NGOs in the critical early stages of the project cycle -- project identification and design. A recent study of the role of NGOs in 39 World Bank-supported projects Asia found that in more than half of those projects, NGOs were involved in identification

Box 3
Putting Heads Together: Public/Private Consultation in Ghana

Since launching a comprehensive economic reform program in 1983, Ghana has enjoyed considerable progress in stabilizing the economy and sharpening its market orientation. The anticipated supply response from the domestic formal private sector failed to materialize, however, due among other things to apparent ambiguities in government attitudes toward the private sector and an inadequate understanding of private sector views on policy, legal and regulatory issues.

The failure of policy reform alone to spur private sector activity led the government, in 1991, to take a more proactive stance. It established the Private Sector Advisory Group (PSAG), consisting of Ghanaian private sector and government representatives. Designed as a forum for public/private cooperation, the PSAG provided a channel for the private sector to make known to government its views on major constraints to operations and growth. The consultative process implicit in PSAG built a sense of ownership and commitment within the private sector to the government's PSD agenda. Early results are encouraging: PSAG quickly identified impediments to private sector growth, recommended ways of eliminating them, and outlined priorities for regulatory and legislative reform. In response, the government amended or repealed laws on price controls, labor regulations, licensing and investment.

Key lessons emerging from the still young PSAG consultation process are:

- careful choice of private sector representation is critical; persons chosen to participate in the PSAG had to have a high degree of personal standing in the business community and a sound understanding of both domestic and global issues;
- initial stages of the process are fragile and require substantial support by way of informal discussion and development of a framework for managing the consultative process;
- initially, the process should focus on reforms that alleviate discrete, readily identifiable concerns of the private sector in fundamental areas such as investment, taxation and regulation.

and design.[11/]

11/ *Bhuvan Bhatnagar, Non-Governmental Organizations and World Bank-Supported Projects in Asia: Lessons Learned, Asia Technical Department Paper Series, No. 2. Washington: The World Bank, 1991.*

23. **Privatization.** High costs and poor performance of state-owned enterprises have spurred privatization in many developing (and developed) countries. Governments have also privatized to increase the size and dynamism of the private sector, distribute ownership more widely throughout the population, encourage private investment, and reduce the administrative burden on an overextended state apparatus. Privatization transactions in developing countries totalled US$56 billion over 1988-92. Latin America, where privatization continues to be an integral part of countries' economic strategies, accounted for most of the activity, some 70 percent of transaction value. During this period, the Bank financed 51 operations with privatization or enterprise restructuring components in 21 LAC countries.

24. The World Bank Group supports privatization as a means toward achieving its broader goals of economic development and poverty alleviation. When it is correctly conceived and implemented, privatization can foster efficiency and encourage investment, outcomes which in turn spur increased economic growth and employment. Between the beginning of 1991 and mid-1992, the World Bank approved 59 investment operations and 42 adjustment operations with components addressing privatization or restructuring of public enterprises. The IFC, which has made privatization a central and expanding element of its investment program, undertook 11 privatization transactions in FY92 alone. The IFC is also involved in privatization advisory work, a substantial portion of which is in Eastern Europe.

25. Privatization has taken on a special urgency in the former socialist countries, where it is a cornerstone of the transformation from command to market-based economies. In the countries of Central and Eastern Europe (CEE), privatization has proceeded more slowly than anticipated. But initial experience has proved instructive for subsequent initiatives, such as the recently approved World Bank loan to support the Russian government's ambitious mass privatization program -- the largest privatization effort ever attempted -- involving some 25,000 large and medium sized state-owned enterprises and many times more small businesses. Indeed, despite the setbacks, some progress has occurred. In Poland, for example, some 100,000 retail businesses were privatized in the 1990-92 period, while 25,000 small enterprises in what are now the Czech Republic and Slovakia were sold by the end of 1991.

26. Pioneering work on privatization in Russia was carried out by the IFC; in 1992 it implemented a "model" privatization of 3,000 small-scale enterprises owned by the city of Nizhny Novgorod (see Box 4). The IFC is now involved in additional model privatization efforts in the Russian cities of Volgograd, Tomsk, Novosibirsk, Chelabinsk and Nizhny Novgorod.

Box 4
Nizhny Novgorod: A Model for Mass Privatization

Russia's first mass privatization of small scale enterprises was carried out in Nizhny Novgorod, a city of 1.5 million people. In a program designed by the IFC, and launched in March 1992, some 3,000 retail shops, stores and communal facilities owned by the city were sold at auction to private bidders. The program benefitted from lessons learned in similar privatizations in Poland and what is now the Czech Republic and Slovakia, while the details of its design were tailored to the requirements of Russia's privatization law and regulations and the city's particular needs.

The public auction process emphasized speed, efficiency, and, most importantly, fairness and transparency in the transfer of state-owned assets to private hands. Participation in the auction was open to all Russian citizens, with special incentives for employees of the auctioned enterprises and members of collectives. Careful attention was also paid to minimizing the potential social costs of privatization: about 75 percent of the enterprises' former employees were rehired by the new owners, while part of the auction proceeds went to a fund to help remaining workers displaced by the sales. Cities throughout Russia are now adopting the Nizhny Novgorod model. Based on the success of its involvement there, the IFC, at the request of the Ministry of Privatization, prepared a manual on how to privatize small scale municipal enterprises.

27. Because the magnitude and urgency of these privatization efforts are unprecedented, the WBG, other development agencies and governments alike are approaching them with an openness to learning from mistakes and to strengthening their design and implementation capacities as the process unfolds and new and unforeseen issues arise. With experience, a second generation of design issues has emerged: the importance of transparency, of dealing with the potential direct social costs of privatization, and of establishing a post-privatization environment which stimulates competition, promotes equity and inhibits concentration of ownership and economic power. Transparency can be assured by, among other things, having clear and simply defined bidding procedures, disclosing buyers and purchase prices, and using mass communications to educate the public about the process and explain technical issues such as vouchers. Mitigating direct social costs may involve implementation of measures to minimize the negative impact of job losses. While recent evidence suggests that the negative impact of privatization on labor may in some cases be limited, provision may well have to be made for employee ownership schemes or compensatory measures such as generous severance packages. Building an appropriate post-privatization environment is a complex and multi-faceted task; among other things, it may involve development and administration of an anti-trust regime to safeguard competition, and of regulations to ensure -- particularly

in cases where natural monopolies are privatized -- that vulnerable groups are not denied adequate access to essential services. Potential obstacles to success in this area go beyond technical matters to deeply embedded institutional issues that may only be slowly resolved. Attempts to establish regulatory bodies often immediately come up against problems related to ensuring their independence from vested interests in both the public and private sectors. Other lessons emerging from privatization experience include:

- Local institutional capacity, if weak, must be built up at an early stage in the privatization process. This has proven particularly important in Africa.
- Central credit allocation mechanisms, weak banking systems, and a scarcity of term finance can hinder the growth of privatized, as well as of existing private, firms. The emergence of private firms through privatization or other means may therefore also require a simultaneous (and lengthy) process of financial sector reform. The WBG's current work in transition economies such as Poland, Bulgaria, Romania, the Baltic states, Kazakhstan and Russia is addressing this set of issues.
- Privatization is often accompanied by a need for comprehensive economic reform; the former socialist economies are extreme examples of this. Broad-based reforms contributed to the success of privatization efforts in Mexico and Argentina.

28. The WBG is deepening its understanding of privatization by reviewing global experience. A World Bank research project investigated the welfare consequences of 12 privatizations in four countries.[12/] Although the results of the research should be interpreted in light of the small size of the sample and the absence from it of a low-income country, the findings are nevertheless of considerable interest. The research found that in all but one case, divestiture produced net overall economic benefits, leading to higher investment and productivity, and a movement of artificially low output prices closer to efficiency levels. In no case did divestiture make workers worse off, while in some instances they came out ahead, and in most cases, consumers were unaffected by or benefitted from divesture. Particularly important was the upsurge in investment following privatization, most notably in cases where public enterprises had left demand unmet because of tight budgets. A striking example was the Chilean telephone company, which doubled its capacity in the four years

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12/ *Ahmed Galal, Leroy Jones, Pankaj Tandor, and Ingo Vogelsgang, Welfare Consequences of Selling Public Enterprises, Washington: The World Bank. Forthcoming. The countries covered in the research were Chile, Malaysia, Mexico and the United Kingdom.*

following divestiture. The research showed the importance of policies and institutions to the favorable outcomes.[13]

29. **Private Provision of Infrastructure.** Governments, particularly in Latin America and Asia, are increasingly allowing and encouraging private operators to provide infrastructure services normally handled by public agencies. Private provision of infrastructure is becoming an area of growing interest to both the World Bank and the IFC, and poses one of the newer challenges to be addressed by the WBG. The World Bank's support for private provision of infrastructure has involved a three-pronged approach focusing on (i) privatization of public utilities; (ii) development of regulatory frameworks to provide appropriate mechanisms for pricing privately delivered infrastructure services, encouraging competition and, where appropriate, removing barriers to entry; recent examples of this type of work include Bank-supported initiatives in Thailand, Indonesia and Jamaica; (iii) use of Bank financing to attract additional private capital for infrastructure projects.

30. The latter component, leveraging of Bank loans (or limited loan guarantees) to attract private resources for infrastructure, is an area where the WBG is seeing increasing demand from client countries, and where innovative approaches are being attempted. Achieving success in this area can be difficult because of the lumpiness of most infrastructure investments, and the deterrent effect on prospective investors of country risks, and regulatory constraints and uncertainties. Nevertheless the potential payoff is great in terms of increasing the pool of resources available for basic infrastructure. The World Bank's Cofinancing and Financial Advisory Services Department (CFS) plays an important role in this area. Its recent involvement in the Hub River power project in Pakistan, through the preparation of a partial guarantee mechanism for private investors[14], allowed the World Bank to mobilize US$1.2 billion of private debt and equity capital for the project. Similarly, in a private power project in Jamaica, Bank lending was used to mobilize US$110 million of private debt and equity capital. Interest among client countries in private financing of

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13/ *Another paper -- <u>Privatization: Lessons of Experience</u>, Washington: The World Bank, 1992 -- presented to the Executive Directors of the World Bank, reviewed experience with privatization. It produced a checklist of practical lessons in policy as well as implementation in areas such as preparation for sale, enterprise valuation and financing.*

14/ *The project included an Extended Cofinancing Operation (ECO). ECOs guarantee private investors that a government will meet its contractual commitments under project financing agreements, e.g. commitments to pay for power received from a privately financed power plant, or to permit convertibility of local currency to foreign funds.*

infrastructure projects has extended to sectors other than power, encompassing areas such as toll roads and water treatment facilities. In Egypt, CFS played a key role in structuring private financing for water desalination, sewage treatment and power plants, as well as access roads and other infrastructure necessary to attract additional private investment in hotels and other tourism facilities on the Red Sea.

31. The IFC has recently focused on private provision of infrastructure as a major and rapidly expanding activity; during the current fiscal year infrastructure investments are likely to rise to about 20 percent of new investment approvals, compared to a share of less than 10 percent of the IFC's portfolio last year. Examples of recent activities include investments in the Philippine and Chilean power sectors, project financing for cellular telephone services in Hungary, Mexico and Sri Lanka, expansion of recently privatized rail services in Argentina, and construction of a privately built and operated oil pipeline in Colombia. The IFC's efforts to mobilize private sector financing for such projects (including finance from non-traditional sources[15/]) reflect the need to secure long-term, non-recourse funding for investments that have been traditionally owned by the public sector and financed with government guarantees.

(iii) Financial Sector Reform

32. The role of financial systems in mobilizing savings, managing risk, allocating resources from savers to investors, and facilitating financial transactions means that a well functioning financial sector is central to expanding investment and enhancing productivity, hence to PSD. In the 1980s, governments and the WBG placed increasing emphasis on the need to accompany reform and restructuring of financial institutions with appropriate reforms in financial policy (e.g. interest rates). In the last few years, as more countries liberalized and encountered new problems, increasing attention has been devoted to a second generation of reform focused on creating appropriate legal, regulatory and supervisory structures to realize the full benefits of financial sector reform. Prudential regulation -- including reserve requirements, monitoring of bank loan portfolios and maturity matching of assets and liabilities -- is vital to ensure that the financial system does not undertake excessive risk. Supervision and regulation needs to be comprehensive, covering all of the activities in which financial intermediaries are involved, including non-loan activities. A new set of regulatory concerns lies in achieving a careful balance between, on the one hand, promoting competition and contestibility to ensure efficiency, and, on the other hand, avoiding excessive

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15/ *I.e. sources other than commercial banks, bond issues and pension funds.*

Box 5
Financial Sector Reform in Indonesia: Moving into the Second Generation

Indonesia's experience in financial sector reform is not only generating a second generation of policy interventions, but is also influencing Bank thinking about the strategic sequencing of policy and structural measures. Oil booms in the mid-1970s and early 1980s spurred Indonesia's economic growth, but the government viewed oil revenues as a temporary blessing to be channelled into investments that would assure sustained growth. The method chosen was directed credit: in boom periods banks were instructed to provide cheap credit for investments linked primarily to import substitution and backward integration of heavy industries. When oil revenues plummeted in late 1982 and again in 1986, policy makers saw a need for major reforms. A first round of liberal reforms in 1983 gave banks the freedom to set interest rates and abolished administratively determined credit ceilings. Further actions in 1986 and 1988 resulted in currency devaluation and other market-oriented reforms improving incentives for the banking system and capital markets. The removal of entry barriers and end of market segmentation also contributed to the successful mobilization of funding for private sector growth.

Notwithstanding this progress, the government is now recognizing the need for a new round of financial sector reforms. Rapid growth has exposed weaknesses in the framework of prudential regulations and increased the risk of financial instability. Many banks are weakly capitalized and some may have significant portfolio problems. Unanticipated market concentration has allowed real interest rates to exceed 15 percent. In response, the Government has introduced new laws for the banking sector including higher capital adequacy requirements, loan loss provisioning, lending and exposure limits, limits on bank guarantees on offshore borrowing, financing reporting, and credit rating. In parallel, state commercial banks are being overhauled. The WBG, which long supported Indonesia's economic liberalization, is also supporting further complementary reforms. These include a comprehensive legal, accounting, and financial disclosure framework for companies and an integrated set of measures to encourage the diversification and deepening of non-bank capital markets.

competition that can undermine the stability of the banking system. Greater emphasis is also being devoted to promoting safe and competitive non-bank financial markets. Furthermore, financial sector reform forms part of an integrated sequence of reforms required in many countries to achieve efficient PSD, led by macro-policy reforms to encourage productivity and efficient investment (see Box 5).

33. Underscoring the potential positive effects of properly designed financial sector reform, growing empirical evidence from multi-country studies is showing links between financial sector development and economic growth and improvements in economic

efficiency. The evidence also suggests that the level of financial development predicts future growth and efficiency advances. Recent work probed linkages between financial sector deepening and real sector growth in developing countries; it found that an increase in the ratio of private credit to GDP of 0.42 percent was associated with a one percent increase in real per capita income.[16] Strong relationships between financial sector liberalization and the allocative efficiency of a financial system are emerging from firm-level research. The results of recent studies in Ecuador and Indonesia suggest strongly that market-oriented financial sector reforms lead to an increased flow of credit to more efficient firms.[17]

34. Financial sector reform also appears to ease constraints on private investment by motivating the return of flight capital. The reversal of capital flight in the late 1980s and early 1990s was particularly noteworthy in Latin American countries that had completed successful adjustment programs. Large black market exchange rate premiums, substantial spreads between domestic and international interest rates, poorly developed domestic financial markets and domestic taxes on the financial system which are not harmonized with those prevailing in other countries are financial sector issues often found to be correlated with capital flight.

35. The return of flight capital makes stock market development an increasingly important financial sector issue. Private portfolio flows -- equity and bonds -- to developing countries ballooned from US$8 billion in 1989 to an estimated US$34 billion in 1992. Growth was initially led by bond financing, but since 1991 the use of international share offerings by several middle-income countries to privatize state-owned enterprises (see Box 6), and the opening of many emerging stock markets to direct foreign participation have boosted equity flows. Experience is showing that key factors hindering inflows of equity portfolio capital, apart from lack of host country creditworthiness, include: (i) regulatory impediments to the purchase of stocks and repatriation of income and capital; (ii) underdeveloped accounting standards and disclosure rules; (iii) inadequate investor protection and securities laws; (iv) inefficient settlement procedures; (v) the "thinness" and concentration of many developing country stock markets. Progress in alleviating these constraints has been most notable on the regulatory side: Argentina, Brazil, Colombia,

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16/ *From a forthcoming World Bank study of the financial sector by Gerard Caprio, et. al.*

17/ *John R. Harris, Fabio Schiantarelli, Miranda G. Siregar, <u>How Financial Liberalization in Indonesia Affected Firms' Capital Structure and Investment Decisions</u>, Policy Research Working Paper 997. Washington: The World Bank, 1992.*

Box 6
Cote d'Ivoire: Capital Market Development

The government of Cote d'Ivoire implemented, over the past year, a program to restructure the Abidjan Stock Exchange (BVA). The aim was to improve its efficiency and facilitate the Ivoirian privatization program, which targets for divestiture 80 state-owned enterprises with an estimated book value of US$800 million -- an amount exceeding the total 1990 market capitalization of the BVA.

The BVA began operation in 1976 but, despite considerable external assistance, has fallen far short of fulfilling its intended role. Only 23 companies are listed, there have been no new listings since 1983, and market capitalization as a proportion of GDP was well below the norm for a developing country stock market. BVA has also been plagued by high operating costs: until recently, the operating budget represented about 25 percent of the volume of transactions. This in turn translated into excessive fees which discouraged investors. In addition, an inefficient quotation system has failed to match supply and demand; brokerage services are limited in scope and quality, and unavailable outside Abidjan.

The restructuring plan was a recognition that the BVA could support the privatization program by providing the process with the critical element of transparency and by creating wider access to ownership of privatized firms. Measures to improve efficiency involved: (i) reduction in annual operating costs, including significant staff cuts; (ii) streamlining of internal procedures and regulations; (iii) modernization of the quotation system; (iv) elimination of listing fees and a 30 percent reduction of quotation fees; (v) establishment of an independent advisory board.

Pakistan and Malaysia have removed many restrictive registration procedures, and foreign investors can now freely purchase listed stocks. Korea partially opened its market to foreign investors in 1992, while India fully opened its stock market to foreign institutions. These developments complement important bank-developed markets and bond markets as sources of private finance.

36. Past WBG operations in support of financial intermediaries sometimes tended to focus narrowly on the credit needs of end-borrowers and did not attend to overall financial sector development. A review of work in this area led to revisions of the WBG's operational approach[18/], putting greater emphasis on (a) the need for sector policy reform to be combined with macroeconomic reform and (b) improvements in financial infrastructure and strengthening of specific financial institutions. Because

18/ *Formalized as World Bank Operational Directive 8.30, February 1992.*

individual financial institutions that operate within a distorted financial system can themselves become sources of inefficiency, the WBG's willingness to support specific financial institutions depends in part on progress in the reform of key macroeconomic and sectoral policies. In addition, the regulatory framework needs to provide appropriate prudential safeguards so that financial institutions behave responsibly. Technical assistance provided by the World Bank in Russia, for example, has identified gaps between Russian banking sector regulations and international norms for accounting, auditing and financial reporting, thus establishing the agenda for reform. In Eastern Europe, bank restructuring and improvements in the regulatory framework have figured prominently: 90 percent of countries with active WBG lending programs undertook projects with components addressing financial sector development in the 1988-92 period. These operations aim to combine institutional changes with policy reforms that establish stability and appropriate incentives.

E. Conclusions

37. There are strong signs that PSD accelerated in the developing world in the early 1990s. FDI flows to developing countries reached an estimated US$38 billion in 1992, a 50 percent increase over 1990; flight capital returned in significant volumes, particularly to Latin American countries; and private investment in developing countries grew to its highest level (as a proportion of GDP) since the peak years of the mid-1970s. Moreover, there is an important qualitative distinction between current private investment activity and that of the 1970s: much of the latter came in response to widespread protectionist policies; today's private investment activity, on the other hand, is likely to have greater developmental impact because it tends to be concentrated in countries that are encouraging competition and seeking closer links with international markets.

38. While there have been considerable advances in PSD in 1991/92, challenges remain. Most notably, private investment response remains sluggish -- in many cases despite intensive adjustment efforts -- in a number of developing countries, particularly the very poor countries of Sub-Saharan Africa and South Asia. In Central and Eastern Europe, the process of privatization, the sine qua non for the transformation from command to market-based economies, is moving more slowly than anticipated as the authorities come to grips with the political, legal, financial and institutional complexities of transferring ownership in the context of economic transition.

39. The implication for the WBG of developments in PSD during 1991-92 is that it must help accelerate the evolutionary process,

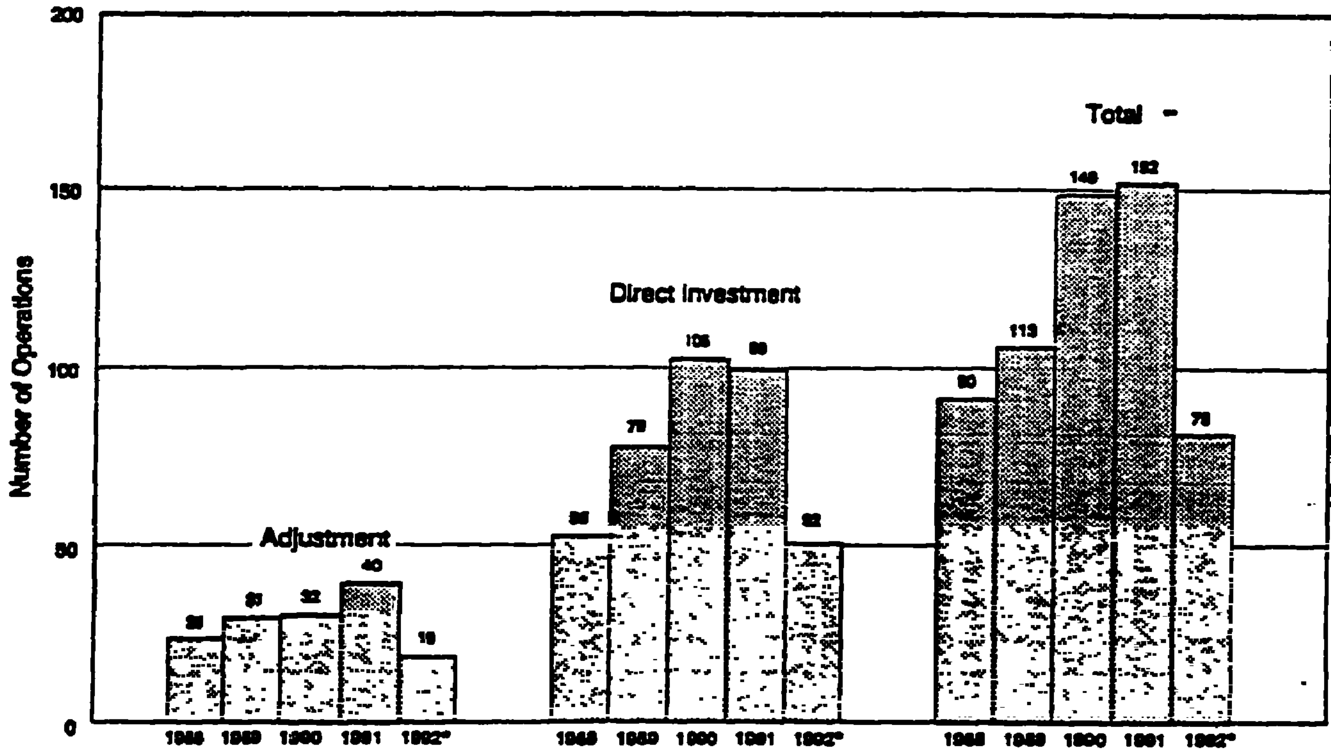
already begun, leading from "first generation" adjustment measures -- which focus on creating a stable macroeconomic framework and an efficient price regime -- to "second generation" measures aimed directly at improving the day-to-day environment in which firms operate.

40. As the delays experienced in privatization programs have shown, tackling institutional barriers to PSD raises a distinct set of issues that go beyond the need to amend policies and resolve discrete technical problems. The dynamics of implementing and sustaining institutional reforms are qualitatively different from those relating to macroeconomic policy reform. Institutional strengthening, and the development of an institutional culture supportive of PSD, are necessarily long and difficult processes, highly susceptible to failure and heavily dependent on unwavering government commitment in the face of conflicting demands from myriad domestic interest groups. The WBG has made progress in supporting governments in this process, but continues to learn from experience. Indeed, the more deeply the Bank Group becomes involved in this work, the more it finds itself having to address unforeseen problems and complexities.

41. To improve its capacity to support governments in the design and implementation of a second generation of PSD reforms, the WBG will look for new ways to (i) understand the dynamics of the environment affecting PSD -- the relevant stakeholders, and the workings of the institutions within which they operate -- with a view to identifying and then devising ways to eliminate, obviate, or work around obstacles to implementation; (ii) forge linkages, as in the case of Ghana (see Box 3) between the various local institutions critical to PSD, so that <u>on their own</u> they can deepen and sustain progress initiated through support from the WBG; (iii) learn from successful country experiences in implementing PSD reforms, and to the extent possible, help replicate those experiences in other countries. The WBG will also seek to improve the skill mix and capacities of its staff in technical areas related to PSD. The World Bank's newly established Vice Presidency for Finance and Private Sector Development, working in collaboration with World Bank operational units and CFS, as well as the IFC, MIGA, and FIAS will be giving a high priority to these issues.

Statistical Information on World Bank PSD Operations

Figure 1



1. The number of World Bank operations with PSD components -- i.e. operations including components addressing the business environment and/or public sector restructuring and/or financial sector development has increased steadily over the past five years, as shown in Figure 1. The 152 operations with PSD components in calendar 1991 represented an increase of 35 percent over 1989 -- the year the World Bank Group's Private Sector Development Action Program was launched -- and a gain of 69 percent over the number of operations in 1988. The number of adjustment operations with PSD components has climbed steadily since 1988, while the number of investment operations dipped slightly in 1991.

2. Table 1 disaggregates World Bank PSD operations by the type of loan -- investment or adjustment -- and by the type of PSD activity supported in the loan. The Table covers projects which were approved during the 18-month period preceding the end of FY92.[1] (The previous Progress Report on PSD covered WBG operations up to the end of calendar year 1990.)

Table 1
New World Bank PSD Operations by Theme and Loan Type: Jan. 1, 1991 - June 30, 1992

	Business Environment	*Public Sector Restructuring*	*Financial Sector Development*
Adjustment Operations	52	42	26
Investment Operations	63	59	61

[1] *Projects may be included in multiple categories. For example, one project which includes components addressing both the business environment and public sector restructuring has been counted in each category.*

FACILITATING FINANCIAL FLOWS TO DEVELOPING COUNTRIES BY JAPAN

1. Overview of the Current Climate

In considering how to facilitate financial flows to developing countries, it should be recognized that in the 1990's, a huge amount of private capital exists and a large scale and deep international financial markets are there, due to accelerated accumulations of financial assets in industrialized countries and vitalized financial transaction across the border during the 1970's and 1980's. However, the aftermath of events from the 1980's to the early 1990's such as LDC debt problems, LBO, and fluctuations in stock and real estate markets, affected the investors' minds to a more cautious attitude for foreign investments, especially those to LDC. As the cold war ends, our development efforts should be more focused on assisting the medium and long-term sustainable economic growth of developing countries and, accordingly, the supply side of development is worth looking into.

Against these backgrounds, the role of International Financial Institutions (IFIs) should be reviewed in a comprehensive manner. Three viewpoints are important in this regard. First, in light of inadequate creditworthiness of many developing countries causing their capital shortages, establishment of strong macroeconomic and sector policies with the help of IFIs is crucially important for obtaining investors' confidence. Second, IFIs could mobilize private flows by sharing several risks appropriately with private investors, when country risks for certain developing countries are so large that private investors could provide such resources by themselves. Third, by identifying true priority areas in recipient countries, official resources should be mobilized in a cohesive and cost-effective manner. Closer collaboration between the IMF, the whole World Bank and regional development banks should be enhanced and furthermore, coordination between these IFIs, related players in the market and bilateral donors should also be encouraged.

In the global perspective of private financial flows to developing countries, there are two points to be highlighted. One is that most of the developing countries are in a position of saving shortage. The other is that there are countries like the former Soviet Union Republics experiencing continuous capital flight or like the Latin American countries where the repatriation of flight capital are mainly of unstable and short-term nature. For these countries, reduction of budget deficits, restraining inflations, and encouraging the private savings should be seriously considered and addressed in order to obtain both internal and external confidence on their fiscal policies. It is also quite essential that industrialized countries should simultaneously enhance their domestic savings through curtailing the budget deficits.

2. <u>Roles of IFIs.</u>

There are several comparative edges in IFIs which have been utilized to a certain extent so far. These include areas such as the following:

First, IFIs can provide not only necessary financial resources for development but also policy advice or guidance in structural adjustment and sector reforms.

Second, IFIs have substantial core information on developing countries, and also internally accumulated good expertise and know-hows on priorities areas or possible policy agenda for those countries.

Third, IFIs can raise less expensive funding which developing countries alone cannot do.

It can be pointed out that while these comparative edges recognized and materialized in the past operations of IFIs should be maintained and expanded, there are still certain areas which need to be developed and strengthened. Generally, IFIs, including the World Bank, have tended to focus on the utilization of their own financial resources and have not been enthusiastic in seeking the possibility of co-financing with bilateral official assistance at early stages of project or program cycles. Consequently, it has been often the case that IFIs solicited the gap-filling to major donors at the final stages or did not succeed in mobilizing the private capitals.

Taking into account the growing importance of private flows including FDI, as a source of fund for development use, serious considerations are necessary in determining the best manner to incorporate the private capital in a project and programs cycle as early as possible. In other words, more active interaction between IFIs and private financial institutions is necessary. In this regard, it should be highly appreciated that IFC, putting its catalytic role at the center of its operations, has set mobilization ratios of private capital on a project-by-project basis and utilized these ratios as important reference indicators.

3. <u>Future Works.</u>

The following works should be explored in the future:

First, the World Bank Group should further explore the strengthening of the guarantee and insurance functions. This will not only enhance private capital flow to developing countries but also contribute to increased investment in infrastructure and assistance to privatization which form the key part of development strategy. Renewed emphasis on guarantee functions will activate interaction between the Bank Group, bilateral institutions and private financial institutions and this would lead to facilitating more efficient operations of the Bank's group. Under this policy orientation, the "B" Loan was introduced in 1933 and Expanded Co-financing Operations (ECO) was introduced in 1989, although the number of projects under these schemes have not increased much in the 1990's. Above all, the ECO program has a number of advantages and does deserve renewed recognition by every party concerned.

The program can:

(i) mobilize a vast amount of funds for big infrastructure projects;

(ii) reduce borrowing cost from private lenders;

(iii) lengthen the loan maturity period;

(iv) facilitate market access to those countries which have great potentiality but no experience of having access to international capital markets.

Now is the time to take a serious look at its reactivation. The Bank should carefully analyze the causes for lower than expected results in the past few years and study bold measures to make this program more attractive to borrowers and private lenders. We should also be reminded that the catalytic role of the Bank Group, accompanied by some strong policy advice, enables a truly global financial intermediation, by facilitating a redirection and diversification of private lenders' interest in developed countries outside of their own traditional region to other regions.

MIGA should also play a greater role in this regard. A steady expansion of its insurance business is, therefore, encouraged and an increase of its membership is also necessary.

Second, the Bank should study more innovative measures to facilitate foreign private lenders' participation in infrastructure projects which used to be financed mainly through public funds. For instance, in East Asian countries, it has been pointed out that high economic growth in the past decade would not be sustainable without properly addressing the bottleneck in infrastructure projects, such as power, transportation and telecommunications. These projects require huge finance resources which could not be financed only by the public sector. The risks contained in these projects are too high to be taken solely by foreign private lenders. Furthermore, some borrower governments are reluctant to increase, by financing the needs in domestic infrastructures, their external debt exposure which have already reached high levels. Under this climate, Build-Operate-Transfer (BOT) operations have some merit; major participation of the private sector in infrastructure building and operation could avoid rigidity in public works and increase efficiency. It may be worthwhile for the Bank Group to study its role and those of recipient governments to facilitate the active use of this method.

THE EXPERIENCE OF DEVELOPING COUNTRIES IN ATTRACTING FOREIGN PRIVATE INVESTMENT: THE CASE OF THAILAND

1. Introduction

In Thailand Foreign investment is important in the development and management of the economy. Foreign investment has been recognized as a valuable channel through which the country can obtain new investment in pioneer industries and investment in those economic sectors which accord with the National Economic and Social Development Plan. As such, Government policies to attract foreign investment have been formulated for the various related factors affecting investment, for example, taxation, capital market development, financial infrastructure, and so on.

The policies implemented by the Government to attract foreign investment involved certain costs. As such, it is of interests to policy-makers, as well as to the public, to know whether the policies implemented were successful. In this light, it is necessary to examine the actual flows of foreign investment to Thailand for the recent years.

From Table 1, it is evident that the flows of foreign investment to Thailand took the quantum leap in the period 1988-90, when the growth rate per annum averaged 52 %. Viewed in the context of overall investment, gross domestic investment grew in the 1987-90 period at the average rate of 32% per year, compared to the growth rate of only about 4% in the 1981-86 period. Thus, foreign investment was the important factor pushing up overall investments in Thailand in the 1987-90 period. (Table 2)

If focus is placed on foreign equity investment in the same period (1988-90), the strong growth of the foreign equity flows here is also observed. From Table 3, the growth rate of foreign equity flows for 1988-90 averaged 40% per annum. The large equity component in the FDI in this period certainly related to certain qualitative aspects of the investment, to be discussed in subsequent sub-sections.

On portfolio investment, from Table 4, the flows were more sensitive to short-term events. The growth rate of foreign portfolio investment in 1989 was 227%, but that rate declined in the following year 68% because of the Gulf War.

Overall, the growth of foreign investment to Thailand in the 1987-90 was relatively high. The factors responsible for the large foreign investment flows can be found in many matters, including, taxation policies; capital market development policies; the general favorable political, economic and social conditions of the country; and others. The following sub-sections will discuss the impacts of the various factors and the policies pursued by the Government affecting foreign investment in Thailand.

Table 1: Net Flows of Foreign Direct Investment to Thailand (1988-1992 Q2)

Period	Amount (million baht)
1988	27,963.5
1989	46,697.6
1990	64,695.0
1991	51,389.1
1991 Q2	10,614.7
1991 Q3	14,631.0
1991 Q4	13,250.3
1992 Q1	10,569.7
1992 Q2	14,654.9

Source : Bank of Thailand

Table 2 Gross Investment at Current Prices —

	1981		1982		1983		1984		1985		1986		1987		1988		1989		1990	
	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates	Millions of Baht	Growth Rates
Gross Domestic Investment (GDI)	194,479	4.1	177,772	-8.6	212,271	19.4	242,306	2.7	243,949	0.6	238,643	-2.2	299,790	25.6	434,346	45.0	559,707	28.9	753,932	34.7
Private business	120,467	4.9	113,415	-5.9	133,065	17.3	150,346	5.1	145,363	-5.2	155,037	4.5	215,565	41.1	329,614	50.6	457,391	38.9	597,325	30.5
Public sector	68,800	10.2	66,463	-3.1	72,924	9.7	82,076	11.4	91,920	12.0	83,573	-9.1	77,452	-7.3	77,727	0.3	92,324	19.0	131,725	42.4

Table 3: Net Flows of Foreign Equity Investment to Thailand (1988-1992 Q2)

Period	Amount (Million baht)
1988	22,780.2
1989	37,407.9
1990	42,939.9
1991	35,531.6
1991 Q2	8,409.8
1991 Q3	10,235.4
1991 Q4	8,987.3
1992 Q1	7,779.6
1992 Q2	11,374.2

Table 4: Net Flows of Portfolio Investment to Thailand (1988-1992 Q2)

Period	Amount (million baht)
1988	11,185.3
1989	36,658.7
1990	11,507.5
1991	928.4
1991 Q2	319.6
1991 Q3	-1,676.9
1991 Q4	795.1
1992 Q1	2,441.1
1992 Q2	-3,083.0

Source : Bank of Thailand

2. Past Performance of the Economy and Foreign Investment

2.1 World economy and causes and effects of foreign currency realignment

After two oil crises in 1973 and 1979, all developing countries were faced with faltering economic situations, especially those with no oil resources. They suffered continuing trade deficits and accumulated huge amounts of debts. Countries which benefitted from the oil crises were OPEC countries and others which derived high income from oil sales. In this period, a worldwide economic recession occurred and continued into the first half of the 1980s. Inflation and interest rates were higher than previously. International trade and investment stalled. By the early 1980's the United States became a net a debtor country and was in serious difficulties with the twin imbalances of budget and current account deficits.

From 1985, the Group of Seven (G-7) interfered in the international currency market in line with the Group's cooperation agreements,namely the Plaza Accord of 1985 and the Louvre Accord of 1986, to alter the trade imbalances among important industrial countries.

After the implementation of the Plaza Accord, the G-7 members realized that the solution to the US trade deficit problem would take some time to realize. Thus, reliance was also given to the Louvre Accord in February, 1987, to ensure that the adjustments of international exchange rates were more reasonable. Other measures were also added, such as calling for Japan and West Germany to rely more for growth on their domestic economies rather than on exports. Japan was also asked to open up more of its market to imports.

The unexpected benefit for Thailand

Japan was greatly affected by the Plaza and Louvre Accords. The agreements created higher prices for Japanese exports because the value of the yen was strengthened from 260 yen per US dollar to 140-150 yen per US dollar. The impacts on the Japanese world market shares were dramatic. Japanese manufacturers tried to maintain their market shares by reducing production costs as much as possible, and one of the ways to do so was to relocate production facilities to countries with a cheaper labor cost, particularly for low value added goods which did not require high technology.

In Japan, the idea of globalization and internationalization, thus, became widely accepted and a large number of Japanese businesses invested more in foreign countries. Thailand, as a consequence, became a production base for Japan, receiving raw materials and equipment, and then producing finished products for export to Japan and other countries.

The impacts of the monetary coordination under the G-7 on Thailand were, thus very significant. They are:-

1. Foreign investment poured into Thailand. In the early period, it came mainly from Japan. Later, when the G-7's intervention failed to reduce the US trade deficit as US consumers merely turned to

imports from NICs such as South Korea and Taiwan, the US turned to press these countries to adjust and strengthen their currencies. The results were similar to what had happened earlier to Japan: South Korea and Taiwan began to invest more in foreign countries. Investments from Japan and Taiwan, had been important for Thailand's rapid economic growth since 1986.

2. Thailand's exchange rate arrangement was such that the US dollar's weight was substantial. As the dollar's value declined, this arrangement decreased the export prices of Thai products and Thailand's export industries benefitted accordingly. Local Thai-Japanese joint ventures producing goods for the domestic market were also able to export significantly because the strong yen had caused their production in Japan to decline. Goods produced by these joint ventures, such as domestic electrical appliances, automobile parts, cars and motorcycles, could now find good export markets.

3. The influx of foreign investors has had several knock-on effects, including a rapid growth of the real estate industry for office and residential buildings, and the development of industrial estates and leisure facilities, such as golf courses. Locally-sponsored supporting industries making, for example, sacking and other packaging products, especially cardboard boxes, have also expanded rapidly, growing in tandem with post-1986 export industries such as shoes, hard disk drives, electronic components, toys, etc.

Foreign investment has also affected Thailand in other ways. The demand for skilled and unskilled labor has increased dramatically, giving rise to many private institutions supplying trained labor for the engineering and other industries. There has also been a dramatic increase in the demand for land to build factories, etc. This has caused widespread land speculation and skyrocketing prices.

An influx of foreign capital

The need for foreign investment is fully recognized in Thailand. Rights and privileges on import duties, taxes and the remittance of profits offered to foreign investors by the BOI are part of a number of incentive measures to persuade foreign investors to invest here. A variety of incentives is also offered by many developing countries needing foreign investment. A good package of incentives will almost certainly attract large numbers of investors. In Thailand, investment from foreign countries, especially Japan, was not insignificant even before 1986, if not spectacular when compared to other ASEAN nations.

After 1986, the Thai economy turned around. Thailand became one of the favored destinations for investors seeking to relocate their production facilities to escape appreciating domestic currencies. This situation during the period 1987-88 was dubbed "Thailand fever". In 1986, the amount of investment seeking promotion totalled Bt. 60.1 billion. Tn 1987, the amount was Bt. 209.0 billion, a staggering increase of 247%. In the following year, the amount increased by a further 154%. The years 1987 and 1988 were indeed Thailand's golden years of foreign investment.

Investment by Japanese of Thai-Japanese joint ventures receiving promotional privileges increased from Bt. 14.6 billion in 1986 to Bt. 24.4 billion in 1987. In 1988, Japanese investment soared to Bt. 77 billion, a three-fold increase. The rate of increase slowed in 1989, but the amount was still high at Bt. 90.6 billion. The combined investment in metal industries and machinery, including electrical appliances and electronics was 21%, 16% and 37% of the total foreign investment in 1988, 1989 and 1990, respectively.

Taiwan and South Korea, the other big investors in Thailand, were also affected by the Plaza and Louver Accords. The US asked both countries to increase the value of their currencies to help ease trade imbalances. Taiwan reacted by investing more in foreign countries, while South Korea seemed more reluctant to do so. Statistics showed that investments in Thailand from Taiwan increased rapidly. The amount of investment from Taiwan increased from Bt. 1.8 billion in 1986 to Bt. 7.7 billion in 1987 and to Bt. 22.3 billion in 1989. The majority of Taiwanese investment was in the electronics industry, plastic products and shoes, almost all for export production. South Korean investment did also increase but only moderately. In 1989, South Korean investment totalled Bt. 4.4 billion.

Another country which increased its investment in Thailand was Hong Kong but for the more specific reason that Hong Kong will revert to the People's Republic of China rule in 1997.

Many Thai businessmen are of Chinese origin and have relatives in Hong Kong , so Hong Kong 's investment in Thailand is seen as something of a family undertaking. Over the past two to three years, Hong Kong's investment in Thailand has increased steadily. In 1987, investment in projects given promotional privileges was only Bt. 3.1 billion. The following year, it reached Bt. 11.4 billion and, in 1989, Bt. 14.4 billion. Most of it went into chemicals, chemical products, machinery and electrical appliances industries.

Singapore was another country which increased its investment to Thailand because of high wage rates and labor shortage in Singapore. Singapore's investment in BOI promoted industries was Bt. 1.6 billion in 1987, Bt.6.9 billion in 1988 and Bt.10.6 billion in 1989, most of it in the production of machinery, electrical equipment and shipping.

These figures demonstrate that the increase in foreign investment since 1988 has come mostly from other Asian countries. These investments played a major part in Thailand's robust growth since 1987. Figures of net foreign direct investment inflows by country and sector during 1970 - 1991 are shown in Table 5.

2.2 <u>Thai economy with its readiness and attraction for foreign investors</u>

Among the factors that brought foreign investors to Thailand, the following may be mentioned.

1. The stability of the Thai economy was an important factor influencing investors to invest in Thailand. Confidence in Thailand was

justified by the fact that in the years following the Second Oil Crisis in 1979, Thailand 's economic expansion rate was still relatively high, which was due mainly to Thailand's balanced economic structure.

2. Thailand, with a population of over 56 million, is a large market . Moreover, the size of the population means that Thailand does not lack labor. Skilled and unskilled wage rates are also low. As such, a large number of labor-intensive industries moved to Thailand.

3. Thailand's domestic and foreign policies remained stable, despite frequent government changes. Policy continuity persisted, especially in the promotion of private investment and the government's support of the private sector. In fact, Thailand's important development mechanism is its bureaucracy's strength and the existence of technocrats.

Another important factor is the reduction in the level of border conflicts with the neighboring countries of Laos and Cambodia, which practically disappeared as Communism receded there.

4. The political changes in Indochina away from Communism gave Thailand a good opportunity to become the economic center of the region. Other countries wanting to do business with Indochina can use Thailand as a base and gateway.

5. The peaceful nature of the Thai society makes it a flexible country, both in its economy and culture which is welcome by investors. Being a Buddhist country may be one factor which has drawn Japanese and Taiwanese investors to Thailand. Another issue which at one time worried foreign investors was labor unrest. Fortunately, this has not been a problem in Thailand because of the country's unique cultural characteristic.

6. The existence of local supporting and complementary industries in Thailand was also an important factor attracting investors. For example, the automotive industry in Thailand has long been established and supported by a wealth of firms making parts, accessories, etc. This has attracted Japanese investors to choose Thailand as a foreign production base for automobiles and motorcycles for export.

Table 5 : Net Foreign Direct Investment Inflows by Country and Sector (billion baht)

Country	1970–1990 Value	1970–1990 Share	1991 Value	1991 Share	1991 Growth
Japan	82.31	41.1%	15.57	30.5%	-44.0%
Hong Kong	20.63	10.3%	11.53	22.6%	53.6%
Taiwan	16.49	8.2%	2.75	5.4%	-61.6%
USA	33.39	16.7%	5.90	11.6%	1.0%
Singapore	12.67	6.3%	6.37	12.5%	7.8%
Netherlands	5.02	2.5%	0.75	1.5%	15.0%
Switzerland	4.45	2.2%	1.21	2.4%	53.7%
West Germany	4.65	2.3%	0.81	1.6%	-29.3%
France	2.27	1.1%	1.15	2.3%	43.1%
Denmark	0.57	0.3%	0.06	0.1%	-16.4%
South Korea	1.16	0.6%	0.29	0.5%	-40.9%
United Kingdom	5.66	2.8%	0.23	0.4%	-78.7%
Australia	0.85	0.4%	1.79	3.5%	1,404.6%
Italy	1.09	0.5%	0.07	0.1%	57.4%
Others	9.08	4.5%	2.59	5.1%	-15.6%
Total	200.30	100.0%	51.07	100%	-18.3%

Sector	1970–1990 Value	1970–1990 Share	1991 Value	1991 Share	1991 Growth
Financial Institutions	7.87	3.9%	8.81	10.9%	77.7%
Trade and Services	65.94	32.9%	13.05	20.9%	-45.5%
Construction	19.72	9.8%	3.35	5.4%	1.7%
Mining and Quarrying	12.34	6.2%	2.07	3.3%	81.3%
Agriculture	2.60	1.3%	0.60	1.0%	-21.6%
Industry	91.14	45.4%	23.35	37.4%	-19.7%
Food	6.92	3.5%	1.54	2.5%	-20.9%
Textiles	7.57	3.8%	1.12	1.8%	-36.2%
Metal and non-metallic	9.58	4.8%	2.20	3.5%	-22.6%
Electrical appliances	32.37	16.1%	6.93	14.3%	-17.5%
Mach and transport equip	5.65	2.8%	2.18	3.5%	-9.8%
Chemicals	11.79	5.9%	3.83	6.1%	-10.7%
Petroleum products	2.74	1.4%	-0.37	-0.6%	-141.8%
Construction materials	0.16	0.1%	0.15	0.2%	1,098.3%
Others	3.45	1.7%	3.77	6.0%	694.5%
Total	200.63	100.0%	51.07%	100%	-18.3%

Source: Board of Investment

3. Government Policies

3.1 The birth of National Economic and Social Development Plan

The modern economic development plans of Thailand had been formulated with precise objectives, targets as well as policies which would be effectively implemented in consistence with the economic and social situation. Dated back to the end of the Second World War, the beginning of Thailand's development process was necessitated by the global economic recession which greatly affected the domestic economy. In approving its first loan to Thailand in 1950, the World Bank sent a team of consultants to closely study the financial and economic situation of the country. The report released by the team on May 28, 1954, "IBRD : Observations on the Financial and Economic Situation of Thailand", was very important to the formulation of the National Development Plans.

On Oct. 20, 1960, the Government of the Prime Minister Sarit Dhanarat launched the first National Economic Development Plan for the period of 1961-1966. Up to the present, the development efforts of Thailand have been guided by 6 Development Plans and the country is now under its Seventh Plan (1992-1996).

3.2 Objectives and results of the 1st-7th National Economic and Social Development Plans.

In order to understand the flow of Thailand's development, the key elements and results of each Plan will be summarized as follows :

First Six-Year Plan (1961-1966)

Objectives : investment in infrastructural construction in the sectors of transportation, irrigation, electricity and other important public utilities; increase in agricultural and industrial production; support of industries to substitute imports.

Results : considerably high growth rate of GDP - 8% p.a.; increase in value of production from Baht 59,000 million in 1960 to Baht 89,000 million in 1966; rapid expansion in value of exports as well as imports; deficit in trade balance but, surplus in balance of payments resulting in increase of international reserve to US$ 800 million in August 1966.

Second Five-Year Plan (1967-1971)

Objectives : following the same direction as the First Plan while expanding development targets to State Enterprises and local administration : 75-80% of development budget was allocated to regional areas.

Results : slowdown of economic growth to 7.5% p.a. resulting from negative external factors at the end of the Plan ; remarkable expansion of basic economic infrastructure, which, however, created problem of unequal income

distribution and widening gap of income as only a part of population benefitted from these basic services.

Third Five-Year Plan (1972-1976)

Objectives : alleviation of income disparity problem by improving productivity in response to expanding domestic markets ; maintaining national economic stability ; reducing population growth rate and expanding public services to regional areas.

Results : negative external factors such as severe fluctuation in world financial system, fall of US dollar, rapid rises of food, raw material and oil prices producing adverse impacts on Thai economy : economic stagnation, high rate of inflation, decline in income and unemployment problem; austere monetary and fiscal measures were implemented ; situation improved at the end of the Plan, reporting the overall growth rate of 7.1% p.a. (compared with the 7% target) and per capita income rose by 4.1% p.a. (compared with the 4.5% p.a. target); as for social aspect, population growth rate decreased from 3.1% in 1971 to 2.6% in 1976, however, public services concerning education and health were still insufficient.

Fourth Five-Year Plan (1977-1981)

Objectives : economic rehabilitation aiming to increase agricultural production, restructure industrial sector to expand exports, improve public administration system, support of investment by creating confidence of investors and protecting domestic-oriented industries, maintain stability of the balance of payments as well as the government budget; improvement of natural resource management aiming to obtain optimum benefit in resource utilization, formulate systematic and consistent directions of land reform and development, survey and development of petroleum and natural gas resources.

Results : economic growth rate was reported at 7.1% p.a., higher than the 7.0 % target, however, agricultural and industrial production increased by lower growth than targeted and agricultural prices could not be maintained resulting in further widening of income gap; trade balance was in deficit as 75% of oil consumption was imported while oil price rapidly rose; Government expenditure increased at a higher rate than revenue due to implementation of economic rehabilitation measures.

Fifth Five-Year Plan (1982-1986)

Objective : development directions were adjusted according to the adverse impacts of the rapid economic expansion during the previous four Plans : rising Government expenditure, poverty problem, bottleneck of economic infrastructure ;

emphasis on export - oriented as well as labor intensive industries ; acceleration of Eastern Seaboard Development Program ; maintaining of financial stability by domestic saving mobilization, economic and financial discipline and support of private participation in solving economic problems.

Results : due to fluctuations in world economy which continued from the second oil crisis, industrial countries turned to the protectionism policy and austere monetary and fiscal measures ; Government efforts to adjust the domestic economy included promotion of exports, especially the adoption of floating system of Baht ; in spite of improvement of international economy at the end of the Plan, agricultural and industrial production increased at a lower rate than targeted; economic growth over the plan period averaged only 5.4%

Sixth Five-Year Plan (1987-1991)

Objectives : dispersion of industries to regional areas ; support of private participation in public infrastructure projects, preservation of the environment.

Results : thanks to favorable world economy since the end of the Fifth Plan, the Thai economy grew rapidly at a rate of 10.5% p.a. and became more internationalized ; monetary and fiscal position was more stable ; per capita income and employment increased ; however, rapid economic expansion resulted in more bottleneck of infrastructure, income gap between rural and urban areas, deterioration of natural resource and environment.

Seventh Five-Year Plan (1992-1996)

Objectives : three main targets were set up to be consistent with the changing international economy : sustaining of economic growth rate at an appropriate level and with stability, redistribution of income and development to the regions and rural areas, development of human resources, quality of life, environment and natural resources.

Results : As of the first year of the Plan the growth rate of world economy was lower than previously projected, the Thai economy in 1992 expanded by 7.4%, lower than the 8% target; it is therefore necessary to make certain adjustments : stimulation of domestic private investment and foreign direct investment, expansion of export market and competitiveness, decentralization of economic activities to the regions.

While Thailand's success can be attributed to many factor, it is believed that the government's commitment to an outward oriented, market-based economic system and a tradition of cautious financial policies all contributed to high economic growth with stability, which was the key to

attracting foreign investment to Thailand.

4. Monetary and Financial - Institution Policies Affecting Foreign Investment

Among the fundamental conditions having the basic influences on foreign investment flows to a country, monetary policies and policies affecting the functionings of financial institutions would be considered important by investors.In these areas,Thailand offers very attractive arrangements and a financial environment that would strongly support investment flows from outside. The important features of the monetary and financial-institution policy outlooks in Thailand can be described as follows.

4.1 Monetary stability : inflation

The success of Thailand in containing inflation while maintaining high economic growth is attributable to the caution and consistency in the conduct of sound monetary policy, which is guided by the monetary aggregate targets determined by the authorities' objectives on inflation, growth, and the balance of payments.

From the record of the macroeconomic management of Thailand, monetary stability in the domestic economy was outstanding. Thai policy-makers have been quite careful about the damages of uncontrolled inflation and have tried their best to keep it down. Monetary expansion have been kept within the bounds of the economic growth of the country throughout the years (Table 6). This tendency to manage monetary growth safely is part of the Thai economic hallmark, which investors can count on its continuity and practice into the future.

The chief monetary policy instruments used, besides the controlled monetary aggregates as mentioned, are Bank of Thailand operations in the repurchase market; lendings by the Bank of Thailand; and the Bank's moral situation. The Bank of Thailand also influences monetary conditions through its intervention in the exchange market.

4.2 Currency soundness

Thailand's currency,i.e. the baht, is managed by policies which ensure its soundness (Table 7). Four fundamental practices and policies in this respect are kept in place that ensures this. First,the baht as a currency is kept internationally convertible by ensuring that not more than 20% of the currency circulating can be backed up by domestic securities and that not less than 60% of the backing up must be in international assets and securities. Today, with the country's international reserve rising to more than the US$22 billion level, the proportion of the international assets of the baht is closer to 90%.

Second, the stability of the baht in terms of its pegging arrangement is very high. The baht is pegged to a basket of the currencies of the world's international trade and Thailand's important trade partners, which has kept the baht quite clear of the chronic global currency volatility. Moreover,the monetary authorities constantly monitor world monetary developments and ensure that the baht's exchange

rate arrangement is adjusted quickly enough to avoid unacceptable external disturbances.As such, investors are not put under the undue pressure of external factors.

Third, the extent of the Government's annual budget deficit is circumscribed by law not to exceed 20% of the budget amount plus the repayment of debt principals. This practice, in effect, ensures that the currency cannot be weakened and destroyed by run-away Government budget deficit.

Fourth, regulations concerning the behavior of public sector borrowings ensure that foreign resources are not overly relied upon and that the debt service burden at any one time is not too high. This practice helps to guard the soundness of the Thai baht in matters concerning the currency's external position.

4.3 International reserve composition and management

Thailand 's international reserve level is presently over US$22 billion which can reasonably support our international trade and investment payments lag equivalent in imports term to a little over six months. (Table 8) The authorities' practice in this matter has always been to maintain the reserve level equivalent to between 3-6 months of import. Since the baht's basket pegging arrangement from 1984 and the event of the 1985 Plaza Accord currency realignment,the international reserve level of Thailand has been rising steadily to the present level. Reserve management has emphasized diversification and stability in relation to world trade and currency arrangements.The management of the reserve reinforces the broader policy to attract investments from the different parts of the world,while the reserve balance indirectly ensures a stable currency environment for foreign investors.

4.4 Financial infrastructure

Thailand's financial infrastructure (Table 9) has several competitive features which make it very much supportive of foreign investment flows. The commercial-banking services are available at the international-standard level. Commercial banks are steadily enlarging their scopes of businesses in order to serve customers better. Recently, the banks have expanded to provide international banking businesses. Of the 15 domestic commercial banks, 8 have international networks, with branches, representative offices and agencies in 13 countries. There are 14 foreign bank branches in the country which help to link up with world financial centers. Recently, 20 mew foreign banks have been granted BIBF operations.

In addition to the commercial banks, there are also near-bank financial institutions. There are 94 of these companies and they offer wide ranging financial services . The remaining financial institutions, accounting for about 15 percent of the financial system's total assets, include various government-owned financial institutions (namely the Government Savings Banks,which mobilizes household savings; the Bank for Agriculture and Agricultural Cooperatives (BAAC), which makes loans to the agricultural sector; and the Government Housing Bank, which helps individuals to purchase houses);the Industrial Finance

Corporation of Thailand (IFCT), a privately owned development institution financed primarily through foreign borrowings (with government guarantees); savings and agricultural cooperatives; credit foncier companies; life insurance companies; and pawnshops.

In addition to the above financial institutions, there are financial markets (the interbank market being the principal short-term market) intermediating the liquidity needs of the system. Supporting these financial flows, the Bank of Thailand operates a repurchase market for liquidity adjustments.

4.5 Official financial incentives

The Thai financial system is essentially a market-based system. Therefore, price signals very much reflect the forces of demand and supply in the financial market. As the Thai economy links up more and more with international markets, it is difficult to ignore external competitive forces. Therefore, financial authorities in principle keep away from creating market-conflicting practices, including giving financial incentives which are not deemed to be desirable.

However, certain basic considerations are in order. As an important policy, the repatriation of profits and earnings of the investments made is permitted and guaranteed by the Investment Promotion Law. The convertibility of the baht was strengthened in 1990 when the Government declared Thailand an Article 8 member of the IMF, which effectively removed all impediments on current transactions in the external account. In addition, the authorities have removed many restrictions in the capital account, thus widening the scope for unhindered flows of capital.

For investments in export-oriented or export-related sectors, the investors can enjoy certain financial facilities provided by the Bank of Thailand for export. This facility is going to be improved shortly by the Government setting up the Export-Import Bank of Thailand to undertake the financing of export and overseas investment by domestic businesses.

4.6 Domestic money market and international linkages

Over the past 4-5 years, the Government has been liberalizing the financial sector in order to enhance its performance in the new global and domestic environment. Many of the measures implemented helped to transform the domestic money and other financial markets along modern practices and increased their efficiency. For example , in 1987, the authorities removed restrictions on interest rate movements in the banking system. (Table 10) Foreign exchange transactions were liberalized, namely, foreign exchange earners were allowed to open foreign exchange accounts with commercial banks in Thailand up to $500,000 for individuals and $5 million for corporations. Thai investors can freely transfer up to $5 million abroad for direct investment. The package also permits free repatriation of investment funds, including dividends and loan repayments, without the prior approval of the Bank of Thailand. The scope for commercial bank to approve foreign exchange transactions

without seeking prior approval from the Bank of Thailand was also increased.

The remaining restrictions are now only limited to resident purchases of property, financial instruments, and equity abroad, which are subject to prior approval by the Bank of Thailand.

4.7 Financial instruments for investors

To offer investors full opportunities in the market, the Thai financial system offers a wide range of instruments to back up and assist transactions of the investors. Channels for investing in the short-term money market, near-term financial markets and long-term markets include the CD's, commercial notes and paper, bonds, debentures and other instruments. Table 11 shows the transactions in financial instruments in 1990.

Table 6 : Money, Credit and Inflation

(% increase)

	CPI	M1	M2	Credit
1980	19.7	12.8	22.5	18.8
1981	12.7	3.2	16.3	16.8
1982	5.2	6.8	24.2	22.4
1983	3.8	5.2	23.8	25.6
1984	0.9	7.0	19.4	17.1
1985	2.4	-3.3	10.3	8.4
1986	1.9	20.4	13.4	6.1
1987	2.5	28.0	20.2	17.6
1988	3.8	12.2	18.2	15.6
1989	5.4	17.6	26.3	19.8
1990	6.0	11.8	26.7	26.9
1991	5.7	13.8	19.8	24.0
1992	4.1	18.0	17.0	19.0

Source: Bank of Thailand

Table 7 : Exchange Rates, 1980-1991

(in baht)

	SDR	US$
1980	26.31	20.48
1981	26.77	21.82
1982	25.37	23.00
1983	24.08	23.00
1984	26.61	23.64
1985	29.27	27.16
1986	31.96	26.30
1987	35.57	25.72
1988	33.97	25.29
1989	33.76	25.70
1990	35.98	25.58
1991	36.16	25.52

Source : International Financial Statistics , IMF

Table 8 : Thailand's International Reserve and Composition, 1980-1990

(Unit: US$ million)

	Foreign Exchange	Reserve Position at the IMF	SDR's	Gold	Total Reserve and Gold	Value of Import
1980	1,552	-	8	1,466	3,026	9,967
1981	1,671	-	61	995	2,727	10,713
1982	1,513	-	25	1,114	2,652	9,186
1983	1,561	30	16	949	2,556	11,034
1984	1,890	28	2	768	2,689	11,096
1985	2,157	32	1	813	3,003	10,160
1986	2,736	35	33	972	3,776	10,219
1987	3,906	41	60	1,204	5,211	14,361
1988	5,906	39	61	1,015	7,112	21,337
1989	9,461	38	16	993	10,508	27,127
1990	13,247	45	13	968	14,273	35,700

Source : International Financial Statistics , IMF

Table 9: Financial Infrastructure

	Assets (in billions of baht)									
	1970		1975		1980		1985		1990	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Bank of Thailand	30.31		56.23		142.72		223.93		478.37	
Banks	51.29	94.6	141.97	80.4	362.62	79.6	813.34	80.5	2,017.01	80.0
Commercial banks	43.18	79.6	121.83	69.0	307.21	67.4	716.28	70.9	1,799.45	71.4
Specialized banks	8.13	15.0	20.14	11.4	55.41	12.2	97.06	9.6	217.56	8.6
Government Savings Bank	6.28	12.6	14.15	8.0	27.97	6.1	54.89	5.4	134.62	5.3
Bank for Agriculture and Agricultural Cooperatives	1.31	2.4	5.18	2.9	17.33	3.8	28.47	2.8	52.08	2.1
Government Housing Bank	-	-	0.81	0.5	10.11	2.2	13.70	1.4	30.86	1.2
Nonbank Financial institutions	2.94	5.4	34.50	19.6	93.07	20.4	196.50	19.5	502.86	20.0
Finance and securities Companies	-	-	23.00	13.0	64.79	14.2	130.96	13.0	343.14	13.6
Credit foncier companies	-	-	1.29	0.7	4.10	0.9	4.48	0.4	4.26	0.2
Small Finance Corporation of Thailand	0.05	0.1	0.06	-	0.08	-	0.08	-	0.08	-
Industrial Finance Corporation of Thailand	0.44	0.8	1.48	0.8	4.15	0.9	14.98	1.5	36.57	1.5
Savings cooperatives	0.69	1.3	1.72	1.0	4.42	1.0	15.18	1.5	58.02	2.2
Agricultural cooperatives	0.79	1.5	3.22	1.8	5.92	1.3	8.17	0.8	10.01	0.4
Pawnshops		-	1.51	0.9	3.18	0.7	5.07	0.5	7.81	0.3
Life insurance companies	0.97	1.88	2.22	1.3	6.45	1.4	17.64	1.7	44.97	1.8
Total	54.23	100.0	176.46	100.0	455.69	100.0	1,009.84	100.0	2,519.87	100.0
Assets/GDP (percent)	38.8		59.1		69.2		99.6		121.2	

Table 10 : Important Financial Rates

(%)

Year	Discount rate	Money Market Rate	Government Bond Yield
1980	13.50	14.66	13.00
1981	14.50	17.25	13.06
1982	12.50	14.95	13.85
1983	13.00	12.15	11.13
1984	12.00	13.58	12.41
1985	11.00	13.48	12.11
1986	8.00	8.07	9.11
1987	8.00	5.91	7.48
1988	8.00	8.66	7.50
1989	8.00	-	-
1990	12.00	-	-

Source: Bank of Thailand

Table 11 : Transactions in Financial Instruments

	(in billion baht) ^S1990^S
Short-term instruments	44.6
Treasury bills	25.7
Commercial paper	17.2
Certificates of deposit	0.1
Notes	1.6
Long-term instruments	40.8
Government bonds	11.3
State enterprises bonds	6.7
Bank of Thailand bonds	13.4
Debentures	2.4
Floating rate notes	7.0

Source: Bank of Thailand

5. Fiscal and Tax Policies

5.1 BOI and investment promotion measures

The Board of Investment (BOI) is the principal government agency providing incentives to stimulate investment in Thailand. The BOI also conducts extensive investment promotion activities both in Thailand and abroad. The summary of incentives under the Investment Promotion Act B.E. 2520 (1977), as amended by the Investment Promotion Act (No. 2) B.E. 2534 (1991) is shown as Annex A.

5.2 Type of taxes in Thailand affecting foreign investment.

The following taxes more or less influence the flow of foreign investment. Details of each tax are shown as Annex B.

5.2.1 The Corporate Income Tax
5.2.2 The Petroleum Income Tax
5.2.3 The Individual Income Tax
5.2.4 The Non-Resident Withholding Taxes
5.2.5 The Value-Added Tax
5.2.6 The Import Duties
5.2.7 The Export Duties
5.2.8 The Excise Taxes
5.2.9 Other taxes
- the stamp duty

5.2.10 Local Government Taxes

a. The House & Rent Tax
b. The Land Development Tax
c. Local government taxes on goods & services

5.2.11 Tax Incentives

The progress Thailand achieved over the years has significantly altered the economic structure of the country. Industrial output has now exceeded agricultural output in the GDP. The Ministry of Finance has embarked upon a complete overhaul of the tax structure since 1991. The underlying philosophy behind these reforms can be described as follow.

1. To improve the competitiveness and the investment climate of the Thai economy.
2. To promote the efficiency of production.
3. To promote sound financial market development.
4. To assure equitable and transparent tax treatment and tax compliance.
5. To put Thailand in a proper light as a responsible member of the global society by further liberalizing tariff duties consistent with international obligations such as GATT.

5.3 Effectiveness, pros and cons of tax incentives

5.3.1 Views and Opinions on the Adequacy of Tax Incentives

Two opposing views and opinions on the adequacy of tax incentives are coexisting in Thailand. The first view is that the incentive package granted by the BOI Act is quite adequate and in fact a degree of redundancy exists.

Those who take this view have the following reasons.

1. Investment decision depends on the tax factor as well as a number of non-tax factors. The significance of the tax factor is substantially diluted by the influences of other non-tax factors. Political stability, the adequacy of necessary infrastructures, the availability of financial infrastructure and the strength of labor unions, among others, are non-tax factors that play a pivotal role in determining investment decision. Investors generally have far-sighted business outlook so that they take account of the overall picture want of the economy in which they want to invest.

2. If the investment decision has already been made, granting more tax incentives become redundant. This argument may stem from the fact that foreign investors have to invest in Thailand to maintain the market share of their products because their competitors become increasingly dominant or threaten to capture the whole market share.

3.Tax incentives induce unfair competition between enterprises in general who pay full tax and promoted enterprises who have the privileges of paying tax at reduced rates or being exempt from tax. In this connection, small Thai businesses tend not to be able to compete with large promoted companies. This, as a result, may create detrimental effects or even destroy the potential foundation of the Thai economy.

4. Tax incentives result in losses of revenue, invite retaliation by other countries (in case of export firms) and unnecessarily make the general tax rate too high.

The second view is that tax incentives granted under the Investment Promotion Act B.E. 2520 are not adequate and not attractive enough to induce foreign investment. These officials see that promoted firms are firms which are preferred and deserved having privileges.

5.3.2 Redundancy Rate

A study by the Industrial Management Company (IMC) on Fiscal Implication of Investment Incentives & Promotion Efficiency found that the redundancy rate is 70%. The redundancy rate is the proportion of promoted investment which would have occurred without promotion.

The study first investigated the average financial rates of return for promoted and non-promoted firms and found that the average financial rate of return for promoted firms was 21.4% and that for non-promoted firms was 20.2%. The difference is therefore less than 2%. Next, the opportunity cost of capital is supposed to be the rate of interest at which enterprises could borrow or lend in the money market and is assumed to be at 15%. Thus any promoted enterprises now carrying a financial rate of return of X% could not have existed without the promotion if X-2% is

less than 15%, the opportunity cost of capital. In other words, any promoted enterprises carrying a financial rate of return below 17% needed the promotion for their existence, and those carrying rates equal to or higher than 17% should have existed even without the promotion. Based on the available data, the study found that 31% of the promoted activities had financial rates of return below 17% so the redundancy rate is 69% or approximately 70%.

5.3.3 Abuses of Tax Holidays

In a survey conducted by the IMC for the Fiscal and Tax Policy Division, Fiscal Policy Office, MOF, promoted enterprises ranked tax holidays as the third important incentive. The tax holidays measure is ranked number three because many firms do not make profits during the period of exemption. Thus tax holidays were not effectively used.

However, losses incurred during the holidays period can be carried over to the period after the holidays and are allowed to be deducted from the profit of any year for five years following the holidays period. This provision invites abuses because firms can claim losses during the holidays period and carry their losses over to the period after the holidays. During the tax holidays period, tax audits and investigations are normally not done.

Another possible abuse of tax holidays is the transferring of profits from non promoted activities to the promoted activities. Under this arrangement, the firm will illegitimately reduce its tax payments in respect of its non-promoted activities. Incidences of this type of abuses are found from time to time. The amount of tax involved is difficult to quantified.

5.4 Roles of tax treaties in removing obstacles to FDI

Tax treaties are bilateral agreements, the contents of which vary from one agreement to another. However, negotiations are usually settled not far from the standard Thai draft which is somewhat similar to the UN model. Thus it could be said that, generally, the DTA would have the following effects on the basic tax rates and rules.

5.4.1 Income from the Operation of Aircraft in International Traffic

Without the DTA, the income tax rate on the operation of aircraft in international traffic is 3% of the gross sales. Under the DTA, this rate is reduced by half to 1.5%. This reduction is only applicable to the operation of aircraft but not to the operation of ship in international traffic.

5.4.2 Dividend

Without the DTA, dividends paid by a Thai company to nonresident individuals are taxed at the progressive income tax rates ranging from 5% to 37%. Dividends paid by a Thai company to nonresident company are subject to a withholding tax of 10%.

Under the DTA, dividends paid by a Thai company to nonresident individuals are treated as prescribed by domestic tax laws. However,the tax rate must not exceed the cap as stipulated by the DTA.

5.4.3 Interests

Without the DTA interests paid to foreign individuals and foreign companies are subject to a withholding tax at a rate of 15%. Interests paid to foreign government are exempt from tax.

Under the DTA, interest paid to the financial institutions of the treaty partner is capped at 10% whereas interest paid to all other residents of the treaty partner is capped at 25%. Interest paid to the government of the treaty partner is exempt from tax in Thailand.

5.4.4 Royalties

Without the DTA, royalties arising in Thailand and paid to a resident individual is taxed in Thailand at progressive rates, 5% to 37%. A standard deduction of 20% but not more than B 20,000 is allowed. Royalties paid to foreign corporation are taxed at the rate of 25%.

Under the DTA, royalties paid to individuals or corporations who are the residents of the treaty partner are generally taxed at a reduced rate of 15%. For DTA with some countries (Germany, France, Netherlands), a special reduced rate of 5% is applicable to literary, artistic or scientific work.

5.4.5 Business Profits

The DTA has limited the power of Thailand to tax business profits by providing two different rules.

First, the DTA introduces the concept of Permanent Establishment (PE) and specifies that a foreign company from the treaty partner country shall pay tax in Thailand on business profit only when the company has a PE situated in Thailand. The scope of the concept of PE is smaller than that of the concept of carrying on business in Thailand under Art. 76 b is of the Thai Revenue Code.

Second, Art. 65 ter (14) of the Revenue Code prohibits deduction of expenses which are not made specifically for activities performed in Thailand. However, the DTA specifies that, in the computation of profit of a PE, general executive and administrative expenses are allowed to be deducted whether the expenses are paid in or outside Thailand. This means that certain expenses of the headquarters may be deducted as expenditure of a branch.

5.4.6 Treaty Partners

Thailand has signed tax treaties with 25 countries. Treaties which are now enforced are treaties with Sweden, Japan, Norway, Denmark, Germany, France, Netherlands, Korea, Singapore, Italy, Pakistan, United Kingdom Belgium, Indonesia, Malaysia, Philippines, Poland, Canada, India, Austria, Finland, China, Romania, Ireland, and Vietnam.

5.5 ASEAN Free Trade Area (AFTA) and foreign investment

During the last two years, the flow of foreign investment slowed down to some extent as a result of the slump of the global economy. To attract foreign investment, Thailand needs to adjust its role in response to the fastchangingdevelopments in the world economic environment. Regional economic integration becomes a must that all players need to get involved. The European Community has made great strides in their path towards an Economic and Monetary Union, which will govern a market of over 320 million one of people having one of the highest purchasing power in the world. The upcoming ratification of the North American Free Trade Agreement is expected to create another equally large and dynamic trading area.

NAFTA is poised to greatly enhance the prospect of the North American economies and attract huge foreign investments to that region. The emergence of former, centrally planned economies and their embrace of capitalism will not only add a new impetus to world trade,but will also increase our challenge to attract foreign sources of funds. These developments, together with the uncertainty associated with the Uruguay Round of Multilateral Trade Negotiations, make it necessary and urgent for ASEAN to achieve AFTA objectives. Through the opening up of our markets and the pooling of resources, ASEAN,comprising 325 million people with an average income is about US$ 1,100 can maintain its attractiveness to local and foreign investors, and thus improve its position in the global production process and world trade.

To successfully implement AFTA and thereby attract foreign investment, Thailand has to reform tariff structure in conformity with the Common Effective Preferential Tariff (CEPT) Agreement. In addition, Thailand is now in the process of reforming the whole structure of tariff to be consistent with GATT. All of these measures are regarded as general investment provision bestowed undiscriminatingly upon all investors. In so doing, the costs of production to producers locating their companies in Thailand will be substantially curtailed. This may be one of the key determinants of investment decision in Thailand.

Turning to Indochina, the opening up of Laos, Cambodia and Vietnam to foreign investment is a significant initial step in the path towards integrating Indochina into the world economy . Thailand recognizes the importance of this development, and will lend assistance in this crucial integration process. Indeed, the enlarged economic linkages and interdependence will serve as a binding force for Southeast Asian nations in the maintenance and promotion of regional peace, foreign investment, and prosperity.

5.6 Philosophy and trend of providing promotional privileges

Current investment promotional measures can be classified as follow.

1. General measures. These measures, among others, include tariff structure reform, establishment of special investment promotion zone and construction of necessary infrastructures. Such measures have advantages

in terms of neutrality and fairness. As well, they are appropriate measures to solve the problem permanently.

2. Specific measures. These measures are streamlined in accordance with the Investment Promotion Act B.E. 2520 (1977) comprising various investment incentives. The government can utilize such measures to specifically promote target activities. On the other side of the coin, specific measures are unfair to small businesses that do not ask for or are ineligible for investment promotion. These measures inevitably create distortion on the decisions of business firms thereby resulting in inefficient resource allocation in the long run.

The BOI is now putting an emphasis on promoting two main activities, namely encouraging industries to be set up in the regions outside Bangkok and promoting export enterprises. In addition, the BOI takes full account of spill-over effects on environment created by promoted-investment project, technology transfer and development, employment opportunities, and foreign exchange earning.

In the past, the Thai government utilized the Investment Promotion Act to promote specific activities by providing tax exemptions or deductions. When export promotion policy replaced import substitution policy, the government needs to adjust investment promotional policy in such a way that it should be more general. There are five reasons that cause the government to change its strategy.

First, it is increasingly difficult to utilize tariff barriers and non-tariff barriers as measures to promote investment since the world economy is now more open. As a result, every country is forced to reduce the level of domestic protection. Second, the US and EC tend to use various

forms of trade retaliation including countervailing duty (CVD) and anti-dumping (AD)against their trading partners which may substantially nullify the effect of investment promotional measures. Third, in the past, investment incentives under Investment Promotion Act are mainly bestowed upon export-related projects and large projects which require a lot of capital. In this connection, small Thai businesses tend not to be able to compete with large promoted businesses. This may create a detrimental effect on the foundation of the Thai economy. Fourth, specific investment promotional incentives result in loss of government revenue and give rise to monitoring problem from the part of government officials responsible for keeping track of promoted firms. Fifth,specific incentives for encouraging enterprises to operate in the regions out of Bangkok worked in the short run but in the long run they did not fulfill the objective since after the promoted period expired there were still insufficient necessary infrastructures. The government did not fully equip such important elements of investment for those promoted enterprises.

Due to the above shortcomings of specific promotional measures, the government has set new trend of providing promotional privileges as follows. First, the government will set clear policy guidelines putting an emphasis on providing general promotional privileges rather than specific promotional incentives. Some of the measures already implemented were, among others,there placement of out-of-date business tax with the value-added

tax and across-the-board reduction of import duty on machinery to 5%. In

so doing, tax structure will be more neutral and fairer to small businesses or firms that do not receive promotional privileges. Other measures that will be implemented in the near future would be the reform of the whole tariff structure in line with AFTA agreement and GATT. As a result, the cost of production will be lowered since import duty on raw materials will be substantially reduced so that the competitiveness of Thai exports increases.

If all of the above measures are in place, promotional privileges stated in Investment Promotion Act are no longer necessary. Second, Antidumping Law should be reformed in such a way that it is more flexible, practical, and enforceable so that the government can cope with external pressure of unfair practice under the trade liberalization environment. Finally, regarding promotion enterprises setting up plants in the regions outside of Bangkok,effective measures that will not create burden to the government and the economy in the long run would be the following:-

First, the government should have systematic plan of infrastructural development in order to equip concerned investors with sufficient infrastructures. As well, investment plan should be consistent with infrastructural development plan. Specifically, appropriate and sound measures that will not have long run problem will be the establishment of scores of industrial estate in the target areas. Second, the government must contain spill-over and environmental effects in each target jurisdiction at minimum or, if not possible, demarcate specific investment area together with strict environmental control. Third, the government should have resource planning including human resources, emigration, and community setup in accordance with the National Social and Economic Development Plan. Finally, general promotional privileges should not entail problems to the officials whose responsibility is to monitor, supervise, or evaluate the promoted projects.

6. Government Policies on External Borrowing and Debt Management

6.1 Policies on public external borrowing to meet the domestic fund requirement

In order to sustain high rates of economic growth while domestic funding was not sufficient, the Government of Thailand had to rely on external sources of funds to finance the development activities of the country. Taking into account the required size of external funding as well as consistency with the development directions at the given period, the Thai Government was able to implement the infrastructural development projects as well as achieve debt management performance in time along with the fast-changing international economy. This, in turn, also helped maintain Thailand's creditworthiness in world financial markets.

6.2 Transfer of new technology attached with foreign borrowing

Public external borrowing of Thailand in a systematic and continued manner started with the First National Economic Development Plan issued in 1961. During the period of the first four Development Plans, most

of the foreign loans were committed with the multilateral sources : the World Bank and the Asian Development Bank, as these sources also provided technical assistance for project formulation and follow-up of implementation. Thanks to this assistance, not only the objectives of these development projects of the Government and State Enterprises financed by the loans were achieved, but the executing agencies also obtained knowledge and skill to implement large-scale projects requiring sophisticated technology. At the beginning of Thailand's development process, transfer of technology as a part of the foreign loans played an important role in upgrading capability of staff for the public sector. As a result, most of the development targets set up by the first four Plans were successfully attained.

6.3 Borrowing programme

As the public external borrowing directly affected the financial position of the country in gen^ral, the Government then had to bring into consideration the fund requirement of the private sector as well as the status of domestic savings in establishing external borrowing program for each fiscal year. In the Fifth Development Plan, the ceiling of annual external borrowing was set up for the first time at US$ 2,400 million or the total of US$ 12,000 million for the whole period of the Plan. This considerably high ceiling encouraged the public sector to seek funding from external sources while allowing more availability of domestic funds to the private sector.

However, due to the global economic recession during the Fifth Plan period, the external borrowing ceiling therefore had to be restricted to a lower level so as not to produce adverse effects on the financial stability as well as the creditworthiness of the country. Private participation in infrastructural investment and environment conservation was also emphasized in order to alleviate the Government's burden in national development.

6.4 Formulation of debt ceiling, prepayment, refinancing to improve balance of payment, debt service ratio, formulation of national budget

During the period of the Sixth Development Plan, the external borrowing ceiling was set up for each fiscal year as follows :

1987	US$ 1,000 million
1988	US$ 1,000 million
1989	US$ 1,200 million
1990	US$ 1,500 million
1991	US$ 2,000 million

In accordance with the above-mentioned ceilings, the Government formulated an annual external borrowing program for each fiscal year, which includes development projects selected according to the following criteria: consistency with the National Development Plans or the operational plans of the borrowers in case of the State Enterprises, project approval by the Cabinet, urgency as well as readiness of the projects. Therefore, the projects eligible to obtain foreign loans had to be considered and approved by various agencies, i.e. implementing agencies, NESDB as a planning agency and Ministry of Finance as an agency responsible for

public borrowing. This procedure, sometimes taking certain time, had however ensured the feasibility and successful performance of the projects.

During the period of the First to the Sixth Plan, 69.67% of foreign loans were committed to finance the economic infrastructural projects in the sectors of transport and communication, energy and other public utilities, while only few of social development projects received loans from foreign sources.

At present, development of the social sector, human resources and natural resources has been given more priority. It is therefore likely that these sectors would obtain more foreign loans than in the past.

Public external borrowing during the First and the Fourth Development Plans was in response to the requirement of development projects. At the end of the Fourth Plan, the Thai economy had to face the global economic recession which resulted in deteriorating fiscal position, rising debt service ratio (debt burden/foreign earning) which surpassed the ceiling of 9% as well as problems of debt bunching.

6.5 Issuance of commercial paper in foreign markets to improve credit rating and attract foreign investors

Accordingly, the Thai Government had to adjust its policy on debt management to comply with the changing situation of interest rates and exchange rates by setting up the following targets :

1) reduction of cost of borrowing or maintenance of debt service burden not to be higher than the cost at the commitment time,
2) provision of loans with most favorable terms,
3) maintenance of creditworthiness at the level acceptable to the international financial institutions and markets,
4) restructuring of the repayment schedule so that the debt service would not create too much burden,
5) restructuring of the foreign debt portfolio to conform with the position of international reserves and exchange loss management.

Measures of the Government to obtain these targets included refinancing, interest and currency swaps in order to reduce borrowing cost and alleviate problems of bunching. Prepayment was also done to reduce the stock of debt. Consequently, the fiscal position in terms of foreign debt became more stable. This success was well recognized in international financial markets and encouraged the Thai Government to get access to more commercial sources of finance. Thailand then was one of the first countries in Southeast Asia to be able to issue short-term bonds in European markets and long-term bonds in the United States. The creditworthiness of the country was approved by Moody and Standard & Poor.

6.6 Impacts

Due to the policy of the Government to support private investment both in the development projects and in foreign countries, the private sector imported more funds from abroad. As of September 30, 1992, foreign borrowing of the private sector accounted for 20.12% of GDP while public borrowing was only 11.19% of GDP. It is clearly seen that the Thai

private sector earns more confidence from foreign markets, which would allow more opportunity to foreign investors to invest in joint venture projects.

7. Thai Capital Market

The development of the Thai capital market has concentrated on creating a proper legal, fiscal, and institutional framework conducive to increasing the volume and efficiency of the flow of financial resources. The salient features of the capital market can be described as follows.

7.1 Recent development of the stock market and computerization

The Stock Exchange of Thailand (SET) started its operation in 1975. Since then the Thai securities industry has proven itself to be leading in sustained growth. Many measures and instruments have been implemented by the government recently to encourage further development of the Stock Exchange of Thailand (SET). The SET introduced the computerized trading system and the automated matching process named "ASSET" (the Automated System for the Stock Exchange of Thailand) in April 1991 in order to provide efficiency and fairness to all investors. With this system, all executed orders can be confirmed to participating brokers within seconds and since the end of 1992 the computerized trading capacity is upgraded to 200,000 transactions per hour. Furthermore, a variety of information service is provided to all investors allowing them better decision makings.

7.2 The establishment of SEC

In 1992, the Government enacted a new securities law and established a permanent supervisory for the securities industry. This structure helped to lessen the confusion in practice for practitioners, especially listed companies and brokerage firms. Entry into securities markets and related activities were monitored more closely .

The Securities and Exchange Commission (SEC) formulated policies to promote and develop, as well as to supervise, matters concerning securities, securities businesses, the Stock Exchange, over-the-counter centers and related businesses, issue of offers of securities for sale to the public, acquisition of securities for business take-overs, and prevention of unfair securities trading practices.

7.3 Other Modernization Measures

The Securities and Exchange Commission also acted to address the following issues :-

(1) Clarifying the roles of primary and secondary markets

The SEC is responsible for regulating and supervising the primary market while the secondary market is left to the Stock Exchange. The SET would concentrate on the trading of listed securities, while matters concerning primary issues rest with the SEC and the Office of the SEC.

(2) Restructuring the authorities and responsibilities of the SET

As the secondary market function is now left to the SET, some regulatory functions which used to be the power of the SET are transferred to the SEC. In addition, the power to grant listing approval that used to be the power of the Ministry of Finance is now vested in the SET. This will encourage the SET to become a fully self-regulated organization.

(3) Providing the facilities and flexibility to companies in issuing new instruments

Prior to the SEC Act, the process of making on initial public offering was complicated to issuers. Moreover, non-quoted limited companies were not allowed to issue debt instruments. Under the provision of the SEC Act, an eligible issuer of shares and equity-related securities will be restricted to a promoter of a public company. On the other hand, an issuer of debt instruments can be both a public company or a limited company. Significant importance has also been placed upon the disclosure of information by issuers. For this purpose, the issuers must disclose as much reliable information as possible to investors by filing registration statements and draft prospectuses with the Office of the SEC. Furthermore, other instruments such as convertibles, warrants and secured debentures are also recognized as the instruments in mobilizing funds to companies.

(4) Introducing the concepts of trustee

In order to provide better investor protection and lay foundations for the supervision of securitization, the concepts of investors representatives or trustees are adopted, especially in the business of mutual fund management. The law requires that a mutual fund must be registered as a juristic person. A "mutual fund supervisor", which is equivalent to a trustee, must be appointed to ensure that the securities company manages the mutual fund in accordance with the rules and regulations.

(5) Allowing the establishment of over-the-counter markets

The SEC Act also provides a procedure to set up an OTC to facilitate the trading of unlisted securities. As mentioned earlier, public offering of securities must proceed through the Office of the SEC. After that the issuer can apply to the SET to list their securities. If the securities cannot be listed in the SET, they can be traded in the OTC market. The OTC market is in the process of being set up.

(6) Establishing futures and options markets

In order to provide both local and foreign investors with hedging instruments, the SEC Act has provisions for setting up the futures and options markets. However, it requires a separate bill to supervise and regulate these markets.

(7) Providing new securities business opportunities

Securities business is now under the supervision of the SEC while the Bank of Thailand retains the power to supervise finance companies. It is noted that the law also provides the opportunity for other types of financial institutions (e.g. commercial banks and finance companies) to take part in securities businesses if given the license by the Minister of Finance. Furthermore, private fund management is a new securities business designed to accommodate the need of major investors who wish to have professionals to manage their money especially in securities investment.

(8) Supervision and enforcement of securities business

Unfair securities trading practices are criminal offenses with severe penalties under the SEC Act. The investigation in this matter is the power of the Office of the SEC, the independent regulatory body. This is crucial since the effectiveness of the law depends largely on the effectiveness of the enforcement.

It can be said that the enactment of the securities law and the independent regulatory body underlined Thailand's our intention to bring all regulations covering the supervision and development of financial and equity markets under the unified system. Furthermore, it creates not only new business opportunities in the Thai financial market but also surveillance and enforcement mechanisms for preventing market manipulations and insider trading.

7.4. Foreign participation in the SET

In the past, efforts to attract foreign direct investment have received more attention than efforts to attract portfolio investment. Consequently, portfolio investment has only become popular recently in response to the provision of incentives and the favorable outlook for the market in Thailand as in other countries. Foreign trading volume has been increasing gradually over the years, especially in 1992 when the volume almost doubled for that year.

FOREIGN INVESTMENT IN SET

Year	Foreign Investment (million baht)	% of Total Turnover
1982	238.35	2.05
1983	338.91	1.83
1984	1,185.27	5.51
1985	1,596.05	4.84
1986	4,617.20	7.76
1987	25,501.10	10.36
1988	40,276.07	12.86
1989	97,284.96	12.90
1990	180,673.52	14.40
1991	130,162.55	8.21
1992	267,987.12	7.20

Although the Thai stock market is attractive to foreign investors as an emerging market with sound opportunities to invest, there are still obstacles restricted foreign investment, i.e. foreign ownership of Thai securities is subject to certain legal limit. However, release of stockholding limits for foreigners is a sensitive issue as the authorities realize that market openness can also at times make the domestic market more susceptible to overseas volatility. The prime examples of volatility are the rapid changes of the market during the first three quarters of 1987 and the "Black Monday" of October 1987 when the SET suffered a major setback along with other stock markets.

In order to minimize market fluctuations due to openness, the authorities have supported the setting up of more on-shore funds and additional overseas funds for the purpose of mobilizing foreign funds for portfolio investment. At present, there are 10 on-shore funds managed by the Mutual Fund Company and accounted for US$ 719 million. There are also 4 off-shore funds totalling US$ 292 million. It is hoped that these types of organized investment will provide more stability than individual investments which can at times be speculative.

7.5 Development of new instruments

In order to encourage a variety of securities for investors, the promotion of new instruments is now in the process. American Depository Receipts (ADRs) and International Depository Receipts(IDRs)have been lately introduced for Thai companies. Besides warrants and convertibles which are now listed on the SET, non-voting shares and limited voting right shares for foreign investors are also under consideration of the SET and authorities concerned. It is expected that the development of these instruments will more or less relieve the problem of foreign investment in those companies in which foreign ownership has reached its ceiling. In addition, as the SEC Act allows for the establishment of futures and options markets, their establishment is also being studied in order to provide both local and foreign investors with hedging instruments.

7.6 The encouragement of debt market

Prior to the SEC Act, the issue of debentures was limited to only listed companies and some of state enterprises. Therefore, there are only 18 debentures issued by 5 listed companies trading in the SET. Since the returns of these debentures are not attractive to investors, their trading volume in the SET has been fairly low in general.

To encourage the debt market as well as to provide facilities and flexibility to companies in mobilizing funds, the SEC Act allows both public and private companies to issue debentures and secured debentures with the approval of the Office of the SEC. It is noted that before the enactment of the SEC Act, there are only 2 listed companies applying for the approval from the Office of the SEC to issue debentures. With this new regulation, it is hoped that the development of the debt market will be enhanced.

7.7 Institutional investors

Besides promoting local institutional investors, the Ministry of Finance has revised and amended the Revenue Code to provide tax incentives to corporations and their employees in setting up provident funds. In addition, the Ministry of Finance has cooperated with the Ministry of Commerce in revising the ministerial regulations issued by Ministry of Commerce to allow insurance companies to invest more widely in the securities listed on the SET.

Furthermore, the Ministry of Finance has granted more mutual fund management licenses to financial institutions in order to increase the competition in this business. Historically, the mutual fund management license was granted to only one company, i.e. the Mutual Fund Company Ltd. (MFC) which was established in 1975 as an affiliate of the Industrial Finance Corporation of Thailand. At that time, it was not a policy to allow other securities companies to handle this business as we believed that it would be risky for investors if we allowed the private sector to handle enormous amounts of funds mobilized from small investors. But when the market developed rapidly, this practice was revised by the Ministry of Finance and the authorities concerned in order to increase long-term investors. Therefore, in February 1992, the Ministry of Finance allowed other financial institutions to undertake mutual fund management.

Currently, there are 7 mutual fund management companies approved by Ministry of Finance. The closed-end funds handled by these companies amounted to 12,000 million baht. However, they these companies expected to be able to convert their closed-end funds into opened-end investment units in order to provide flexibility to both investors and managers.

Table 12 : ON-SHORE AND OFF-SHORE FUNDS.

Name of Fund	Type	Year Launched	Duration	Value (US$ million)	Parties involved	Listed on
The Thailand Fund	T	1986	25 Years from 1986	30	-IFC -Vickers da Costa -Morgan Stanley -BIL -MFC	London Stock Exchange
The Thai Fund	T	1988	25 Years from 1987	115	-Salomon Brothers -IFC -Deutsche Bank Capital -Morgan Stanley -MFC	New York Stock Exchange
The Thai-Euro Fund	T	1988	50 Years from 1988	75	-Lloyds Invest-ment Manager -Hoare Govett -MFC -Phatra Tanakit	London Stock Exchange
The Thailand Growth Fund	T	1988	25 Years from 1988	50	-Nikko Securi-ties -ADB -Nikko Merchant Bank(Singapore) -MFC	Tokyo Stock Exchange

Name of Fund	Type	Year Launched	Duration	Value (US$ million)	Parties involved	Listed on
The Thai Prime Fund	T	1990	25 Years from 1988	165	-Nomura Securi- -ties -IFC -Nomura Merchant Banking (Singapore) -MFC	London Stock Exchange; Stock Exchange of Singapore
The Thailand Internationl Fund	T	1988	25 Years from 1988	75	-Swiss Bank Corp -Fidelity Inter- -national -MFC	London Stock Exchange
The Thai-Asia Fund	T	1989	25 Years from 1989	50	-Scimitar Asset Mgmt.Asia -Standard Char- -tered Asia -Chintung -MFC	Stock Exchange of Hong Kong
The Thai Asset Fund	T	1989	25 Years from 1989	50	-Elders Finance Group -Elders Finance Pacific -MFC	Stock Exchange of Hong Kong; Australia Stock Exchange
The Thai Equity Fund	T	1990	20 Years from 1990	50	-OCBC -DBS Bank -MFC	Stock Exchange of Singapore

Name of Fund.	Type	Year Launched	Duration	Value (US$ million)	Parties involved	Listed on
The Thai Capital Fund	T	1980	25 Years from 1980	69	-Daiwa Securi--ties (USA) -Merrill Lynch -Daiwa Interna--tional (H.K.) -MFC	New York Stock Exchange
Bangkok Fund	F	1985	15 Years from 1985	67	-BFIT Secutities -First Overseas Bangkok Invest--ment	London Stock Exchange
Siam Fund	F	1987	50 Years from 1988	95	-Asia Securities Trading -Banque Indosuez (Geneva) -Indosuez Asia Investment Services	London Stock Exchange
Thai Investment Fund	F	1988	50 Years from 1988	30	-Asia Securities Trading -Yamaichi Interna--tional(Europe) -Yamaichi Capi--tal Management (Guemey)	London Stock Exchange
JF Thailand Trust	F	1989		100	-Jardine Fleming Trust Manage--ment (London)	Stock Exchange of Hong Kong

Note : T - Registered in Thailand F - Registered outside of Thailand

Sources : The Mutual Fund Co., Bank of Thailand, Nomura Securities Co. (Bangkok)

8. Conclusions and Recommendations

Thailand's experience with foreign investment came to the international attention in the 1988-90 period when the flows of foreign investment in that period increased at the very high rates of about 52% per year . Viewed alongside the high economic growth rates of the country in that same period of about 11.5% per annum, observations as well as tentative conclusions, were made that the investments were instrumental in putting Thailand on the high-growth track. Attention thus turned to the factors which brought all those investment flows from overseas to Thailand. As the preceding six sub-sections have laid out the facts and discussed the various aspects related to foreign investment, the more compelling explanations of Thailand's success in attracting foreign investment , as well as for the foreign investment boom in Thailand, lay in the overall policies of the Government, the general favorable economic environment in the country and the positive social factors existing in Thailand, as opposed to the strength of the selective approach to investment promotion.

The specific experience of the 1986-89 should prove the above point conclusively. The factors which contributed to the performance of the Government's policies and the improvement and stabilization of the general economic and social environment are now recognized as internally having the strong influences in attracting foreign investment. For example, the policies and measures to undertake the structural adjustments of the economy, both as prescribed in Thailand's social and economic development plans and as advised by the World Bank, are recognized as contributing significantly to Thailand's readiness to take on the changed world economic situation after the Plaza Accord in September 1985. The ensuing drops in the interest rates and the oil prices in the first half of 1986 merely triggered the dramatic expansions in the Thai economy continuously for the next four years. The Thai stock market boomed relentlessly as foreign capital sought safe and profitable destination and haven. Export took off, in turn triggering the need for more foreign capital inputs and technology. Gross investment took big leaps from 1986 on (See Figure 1). Foreign investment, likewise, grew at very high rates (40-60%) in the years 1987-90 (Figure 2).

The hindsight gives us the benefit to look back and put all the factors in perspective. In hindsight, the realignment of the major currencies by the Plaza Accord in September 1985 was the single most important event affecting the Thai economic and foreign investment boom in the 1987-90 period. Nonetheless, as mentioned previously, other factors did also contribute to the high-growth rates of foreign investment and of the economy, but their overall orders of impacts are judged not to be more than the event of the realignment.

Finally, for recommendations on private foreign investment based on Thailand's experience, the following may be mentioned.

(a) For the host government, the maintenance of proper and stable macroeconomic stance for the country is important in order to create the immediate, economic environment which foreign investors can have confidence in and be motivated by the opportunities for successful investment. The maintenance of the general economic and

social conditions which are conducive to foreign investors are also important. Additionally, the host government should work on measures in related areas, specifically, in taxation, financial system supervision, government finance and capital market regulation and development, to put in place the appropriate measures for private foreign investment. From Thailand's experience, these latter measures would be of general-approach types rather than narrowly focused. Political stability is also a must that individual country should cultivate so as to successfully attract foreign investment.

(b) For the home country, cooperation can be rendered by the home-country government taking necessary measures with regard to their industries and investors which prevent investor behavior which is damaging from the point of view of the global community. Exporting domestic problems to other countries, including in investment forum, and creating damages in these other countries should not be the behavior of the home-country government and investors. Such instances for example, industries destroying forests which adversely affect the ecological balance, mercury-poisoning industries, if occurred, should cause some constructive dialogue between the countries to resolve the conflicts, inherent and otherwise.

(c) For the multilateral institutions, the encouragement for balanced economic development should be pursued. Where advanced countries can render the appropriate cooperation to less advanced countries, some forums should be constituted in the multilateral institutions to make that possible.

Figure 2 : Gross Investment in Thailand

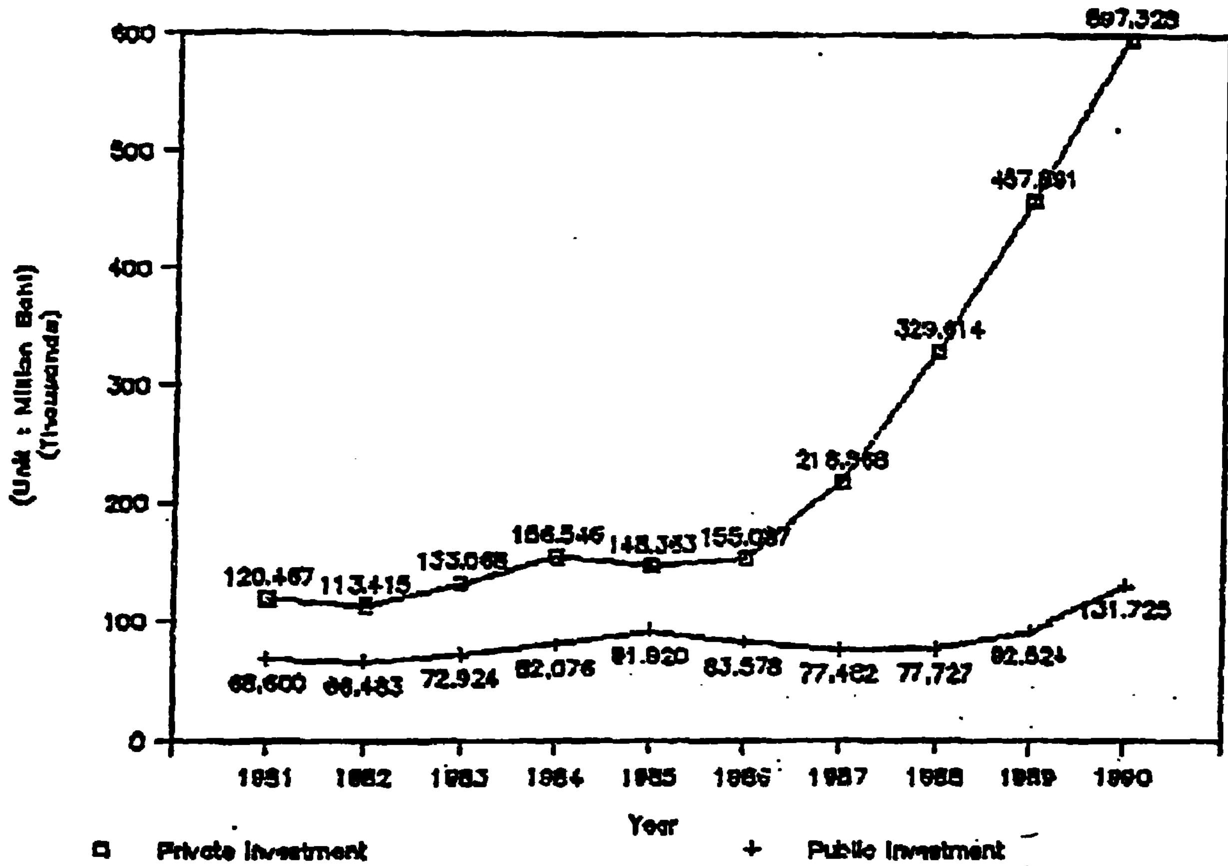


Figure 1:
Net Flows of Foreign Direct Investment

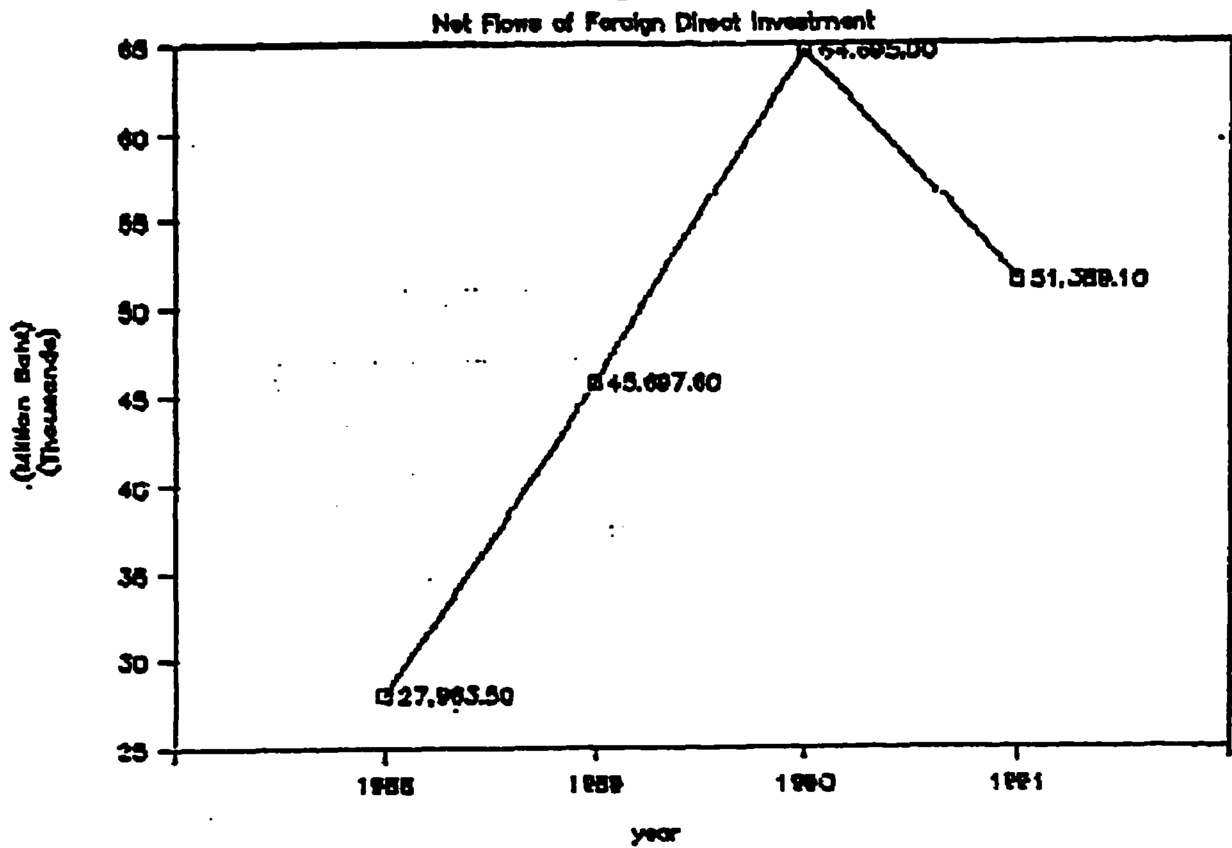
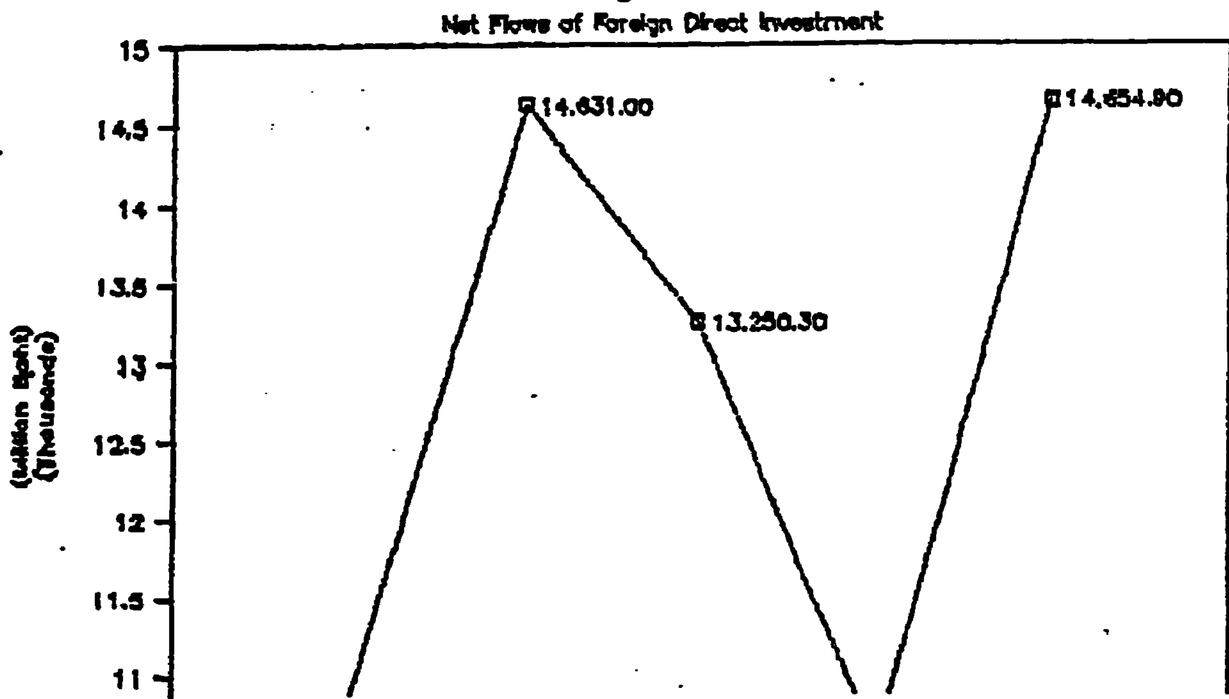


Figure 1:
Net Flows of Foreign Direct Investment



Annex A

Summary of Incentives under the Investment Promotion Act

1. Guarantees
   - Against nationalization; competition of new state enterprises; state monopolization of the sale of products similar to those produced by promoted person; and price controls permission to export; imports by government agencies or state enterprises with taxes exempted

2. Protection Measures (subject to justifications and needs)
   - Imposition of surcharge on imports at a rate not exceeding 50% of the CIF value for a period not more than 1 year at a time
   - Import ban on competitive products
   - Authority by the Chairman to order any assisting actions or tax relief measures for the benefit of promoted projects

3. Permissions
   - To bring in foreign nationals to undertake investment feasibility studies; and in foreign technicians to work on promoted projects
   - To own land for carrying out promoted activities
   - To take or remit abroad foreign currency

4. Tax Incentives
   - 50% import duty reduction on machinery which is subject to import duty greater than or equal to 10%
   - reduction of up to 90% of import duties on imported raw materials
   - Exemption of corporate income taxes for 3 to 8 years with permission to carry forward losses and deduct them as expenses for up to 5 years
   - Exemption of up to 5 years on withholding tax on goodwill, royalties or fees remitted aboard
   - Exclusion from taxable income of dividends derived from promoted enterprises during the income tax holiday

5. Additional Incentives for Enterprises in the Special Investment Promotion Zones
   - Reduction of 50% of corporate income tax for 5 years after the termination of a normal income tax holiday or from the date of income earning
   - Allowance to double the cost of transportation, electricity and water supply for deduction from taxable corporate income
   - Allowance to deduct from the taxable corporate income up to 25% of the investment costs of installing infrastructure facilities for 10 years from the date of income earning

6. Additional Incentives for Export Enterprises
   - Exemption of import duties on imported raw materials and components
   - Exemption of import duties on re-exported items
   - Exemption of export duties
   - Allowance to deduct from taxable corporate income an amount equivalent to 5% of an increase in income derived from exports over the previous years, excluding costs of insurance and transportation

Annex B

Taxes Affecting Foreign Investment

5.2.1 The Corporate Income Tax (CIT)

The CIT is imposed on profits of companies registered in Thailand as well as companies registered abroad but carrying on business (through branches) in Thailand (resident companies). The CIT is also imposed on companies registered abroad and not operating in Thailand (nonresident companies) but only on income derived from sources in Thailand (See 5.2.4 below). The tax rates on resident companies are 30% of profits for companies whose stocks listed or not listed in the Stock Exchange of Thailand (SET).

5.2.2 The Petroleum Income Tax (PIT)

The PIT is imposed on oil companies at the rate of 50% of their profits. An oil company is defined as a company with a drilling concession, or a company with a shared interest in a drilling concession, or a company which exports all crude oil purchased from a company with a drilling concession. Taxable income composes of (a) income from sales of petroleum, (b) value of crude oil shipped to oil refinery, (c) value of crude oil which is paid to the government as royalty, (d) income obtained through transfer of assets and rights to petroleum concession and business, and (e) all other incomes obtained in connection with petroleum transaction. Profits are determined by deduction of expenses permissible by the law from the total income. Companies subject to PIT are not subject to CIT.

5.2.3 Individual Income Taxation (IIT)

Individual Income Tax is generally imposed on all income of individuals. These incomes are classified into 8 categories.

- Type of income
  1. Income from employment such as wages & salaries.
  2. Income by virtue of a post or service rendered.
  3. Royalty income such as income derived from goodwill, copy right etc.
  4. Investment income such as interests, dividends and capital gains.
  5. Rental income.
  6. Income from professional services.
  7. Income of contractors.
  8. Income from business, commerce, agriculture, industry, transport, or other activities not listed above.

- Tax Rates. The IIT rates are progressive ranging from 5% to 37% as follows :

Table 1 : Individual Income Tax Rates

Net income brackets	Rates
not exceeding B 100,000	5%
exceeding B 100,000 but not exceeding B 500,000	10%

"	B 500,000	"	B 1,000,000	20%
"	B 1,000,000	"	B 4,000,000	30%
"	B 4,000,000			37%

- Allowances

Personal Allowance	30,000 Baht
Spouse allowance	30,000 Baht
Child allowance	15,000 Baht
Education allowance	2,000 Baht
The taxpayer is an estate	30,000 Baht
The taxpayer is a non juristic partnership or body of persons	30,000 Baht but shall not exceed 60,000 Baht in total
Insurance Premium allowance	actual amount but not exceed 10,000 Baht
Provident Fund allowance	actual amount but not exceed 10,000 Baht
Social insurance fund allowance	actual amount
Interest allowance for residential purpose	actual amount but not exceed 10,000 Baht
Donation allowance	amount donated but not exceed 10% of remainder of income after the deduction of all the preceding allowances

- Treatment of Capital Income

a) Interest

Although the Thai IIT system is generally based on the global income concept, interest income is specifically treated as follows :

1. Interests from bank deposits and interest received from other financial institution are taxed at source at the rate of 15%. The interest earner has an option either to treat the 15% withholding tax as the final tax and exclude the interest from his income when he files an annual tax return or to report the amount of interest together with other income in his annual tax return thereby submitting the interest income to be taxed at regular progressive tax rates together with other income.

2. Interests from government bonds are taxed at source at the rate of 15% but only when the rate of interest on government bond is higher than the rate announced by the Bank of Thailand (BOT) for saving deposit. In such a case, the tax is charged only on the portion of interest which is accrued as a result of the higher rates. The taxpayer has an option either to treat the withholding tax as final tax or to declare his interest income in his annual return.

3. Interests from private bonds are taxed at source at the rate of 15%. The option to treat the withholding tax as final tax or to declare the interest in the annual tax return is also available.

4. Interests received from non financial institutions are taxed as regular income at progressive rates.

b) Dividends & share of Profits

Dividends and shares of profits are treated as regular income, aggregated with other income, and taxed at the progressive income tax rates. However, the following features are available.

1.Dividends received by individual who is a resident of Thailand from a company incorporated in Thailand are subject to a withholding tax at a rate of not more than 15%. The taxpayer has an option either to report the dividends with his other income in his annual return or to treat the withholding tax as a final tax and not reporting his dividend in his annual return. This option which was formerly available only to dividend received from listed company has been extended to non listed company since Jan. 1989.

2. Dividends received from a mutual fund or a financial institution established under a special law of Thailand for the promotion of agriculture, commerce or industry may either be taxed at source at the rate of 10% or be excluded from the computation of tax on the final returns.

3. Dividends and shares of profits received by an individual who is a resident of Thailand from a Thai company or partnership are entitled to a tax credit of three-seventh of the amount of the dividend.

The credit received is treated as income and shall be included in the assessable income for the computation of tax. Tax credit is allowed only to taxpayers who choose to report their dividend income in their annual tax returns.

c) Capital Gains

1. Gains from the sales of stocks or shares in the SET are tax exempt (MR # 126 item 23).

2. Gains from the sales of stocks or shares outside the SET are treated as regular income and are taxed along with other income at progressive rates.

3. Gains from the sales of immovable property are entitled to be taxed separately from other income. Liberal standard deduction and income averaging features are also provided. (See Art. 48(4) a and b and Royal degree # 165).

5.2.4 The Non-resident withholding taxes

Withholding taxes are imposed on nonresident companies as well as on nonresident individuals.

Companies Non resident companies are subject to withholding taxes on the following incomes

(a) income under article 70 of the Revenue Code

1. brokerage income
2. goodwill and copyright
3. interest & dividend
4. rental income
5. income from liberal professions

(b) income under article 70 bis of the Revenue Code

Disposal of profits out of Thailand are subject to a withholding tax at the rate of 10% of the profit disposed off. This withholding tax is over and above the corporate income tax of 30 or 35% as the case may be.

Individual

Nonresident individuals receiving income from sources in Thailand are subject to withholding taxes on income in the same manner as resident individuals.

5.2.5 Value-Added Tax (VAT)

The VAT is imposed at each stage of production and distribution chain. It effectively covers manufacturers, importers, exporters, wholesalers, retailers, and any other sellers who sell goods or render services in the course of their business or profession. The general rate is 7% with 0% for exporters. Some businesses are exempted from the VAT including inter alia small entrepreneurs, unprocessed agricultural products, and services necessary for maintenance of life and social welfare such as transportation as well as health care services.

5.2.6 The Import Duties (ID)

The ID is imposed on most imported goods at varying rates ranging from 0% to 100%.

5.2.7 Export Duties (ED)

The ED's are imposed on 4 products namely, hides, rubber, wood, and raw silk.

5.2.8 The Excise taxes (ET)

The ET's are levied on 11 commodities namely, non alcoholic beverage, spirits, tobacco, playing cards, petroleum and petroleum products, air-conditioners of not over 72,000 BTUs per hour, crystal glass, motorcars and buses seating under 10, yachts, perfume and house-racing course.

5.2.9 Stamp Duty Stamps are required to be affixed on various financial & legal instruments and documents.

5.2.10 Local Government Taxes

The local government levies a number of taxes, the major ones of which are the House and Rent Tax, the Land Development Tax and the local government taxes on goods & services.

a) The House & Rent Tax

The House & Rent Tax is a form of property tax imposed on land and buildings for industrial and commercial use and on residential land and building not occupied by owners. Owner occupied residential buildings are exempt from tax. The tax is based on the annual rental value.

b) The Land Development Tax

The Land Development Tax is based on the land value. Properties subject to the House & Rent Tax are exempt from the Land Development Tax & vice versa.

c) The Local Government Tax on Goods & Services

The local government imposes taxes on goods & services as a surcharge of the Business Tax & the Excise Tax of the central government. The tax rate is generally 10% of the tax collected by the central government.

5.2.11 Tax Incentives The Board of Investment (BOI) grants promotional privileges to firms which are engaged in preferred activities. Tax privileges under the BOI are shown as Annex A.

The Experience of Developing Countries in Attracting Foreign Private Investments
The Case of Indonesia

I. Introduction

Indonesia is a diverse archipelagic country with more than 13,000 islands with a land area of about 2 million square kilometers. Its population in mid-1991 was estimated at 181.4 million, and is growing at about 1.8 percent a year. Although income per capita is still low (1991, $610), with an average growth rate of 6% p.a that the country has been able to maintain since two decades ago, the economy will undoubtedly become one of the largest market in Asia in the near future.

In response to a series of external shocks faced during the 1983-88 period, the country has successfully implemented a comprehensive adjustment program. One of the main features of the adjustment program was to reduce the dependency of the country on oil which in the early 1980s was the source of 80% of export earnings and 70% of budget revenues. As a result of the adjustment program, by 1992 oil accounted for only 36% of government budget and 30% of export earnings. The policy reforms undertaken by the government during the period covered a wide spectrum of areas including exchange rate, fiscal and financial policies, trade and investment regulations. Trade and financial sector deregulation combined with several deregulation measures in the area of investment have been contributing the most to the improvement of the competitiveness of the domestic industry. This has been reflected in the substantial increase of manufactured goods export which has expanded at 27% a year over the past several years.

II. Policy Measures Taken to Attract Foreign Investments

1. Foreign Direct Investment

Foreign Direct Investment (FDI) has been playing an important rôle in the development of the Indonesian economy. In the late 1960s, the early stage of industrial development

of the country, foreign direct investments were mostly directed toward local market (import substitution policy).

The early efforts to attract foreign direct investment was initiated by the enactment of the Foreign Investment Law in 1967. This law provides the legal framework for FDI in Indonesia. The law contains a number of provisions to attract foreign investments such as by allowing FDI companies to freely transfer or repatriate their foreign exchange earnings, assuring foreign investors that their companies will not be nationalized, granting foreign investors tax holiday, and allowing them to operate in Indonesia for a maximum period of 30 years. Some provisions of this basic law have been amended since then reflecting the government's policy changes toward foreign direct investment.

Efforts to attract foreign investment was substantially strengthened in 1970 by the adoption of free foreign exchange system. The system was liberalized further in 1982 and the exchange rate has become more flexible since March 1983. In order to develop the cooperation between foreign investors and domestic companies, since January 1974 all foreign investments are required to be undertaken in the form of joint ventures with Indonesian partners in which the latter must obtain a majority interest within a specified time period. Furthermore, FDI companies may operate in an area which is otherwise closed to foreign investor if FDI companies cooperate with small scale local enterprises or cooperatives.

In response to the declining trend of foreign investment applications in the early 1980s due mainly to the world economic recession and recognizing the fact that the environment for foreign investments has become increasingly more competitive, the Government of Indonesia has taken a series of policy measures relating to FDI. The most important among them were on:

(i) Taxation, in 1983 the Government implemented a major tax reform. A unified taxation system was adopted which among others removed tax incentives for foreign investors. Under the new tax system,

the maximum tax rate was lowered from 45% to 35% and it also allowed accelerated capital depreciation. With the adoption of this system, the FDI companies got the benefit of lower tax rates to compensate for the lifting of tax holiday enjoyed by them since 1967.

(ii) Investment approval procedures: In 1985, the Government reduced significantly the number of administrative requirements for investment approval. Among the requirements removed were submission of feasibility study of the proposed investment, explanation of the type and value of machineries to be imported, and various licenses and recommendations from different ministries and local government. In May 1989, the Government simplified further the investment procedures by replacing the Investment Priority List with the Negative List, containing only business areas closed to foreign investors. The introduction of the Negative List has removed many ambiguities experienced in the past because it is clear now what fields (business areas) are closed to foreign investments. In the old Priority List system, fields open to foreign firms were listed but it had created considerable uncertainty because sometimes it was not clear whether fields which were not on the list were open or closed to foreign investment. The Negative List has been subsequently revised, the latest revision in June 1991. As it stands now, the business areas closed to foreign investment have been reduced to 60.

(iii) Trade, FDI companies are now allowed to export their own products as well as those manufactured by other companies. In addition, the companies are allowed to establish joint-ventures with private national companies, and to act as the distributor or agency in the marketing of their products in the domestic market. The companies are also permitted to sell their products directly to other companies

which use them as capital goods, spare parts, building materials/equipments, or raw materials/auxiliary goods for their production.

(iv) <u>**Establishment of foreign Banks**</u>: the Government has taken several measures to encourage longer-term investments. In 1991, the minimum maturity on foreign exchange reswap facilities was extended by the central bank to two years. In the banking sector, since October 1988, the Government has increased the number of cities from one to seven where foreign banks are allowed to open sub branch office but limited to only one sub-branch for each bank. Meanwhile, the Government also allowed the establishment of joint-venture banks in the same seven large cities. To establish a joint-venture bank, a foreign bank must previously have a representative office in Indonesia and must be categorized as a major bank in the country of origin, and the country of origin must have a reciprocal relationship with Indonesia.

(v) <u>**Ownership**</u>: In 1992, the Government relaxed the requirements relating to the transfer of majority ownership to Indonesian partners. Under the 1992 reform, FDI company can now be established with a minimum of 5% local shares. This local share should be increased up to at least 20% within a period of 10 years. FDI company may also be established with the authorized capital fully owned by the foreign participant provided that (i) the total paid up capital be at least $50 million, (ii) the company is located in one of the least developed regions, or in a bonded area, and (iii) total products are for export.

Under certain conditions, the Government may reduce the minimum investment requirement from $1 million to $250,000 if the FDI company meets the following conditions:

(a) labor intensive having direct employment of at least 50 persons, and at least 65% of its product is for export, or it produces raw materials/auxiliary material/semi processed goods/components to supply other industries.

(b) carrying out activities in the field of services pursuant to the applicable laws.

Furthermore, pursuant to the 1992 reform, FDI company may reinvest its profits for establishing a new company, or purchasing share in another Indonesian company either in an existing company or in a new company which field of business is not included in the Negative List for foreign investment.

(vi) Legal protection: In 1968, the Government signed the agreement on convention of the settlement of investment disputes. Disputes that may arise from foreign investment ventures in the country therefore can be referred to the International Center for the Settlement on Investment Dispute (ICSID). Indonesia is also one of the founding members of MIGA (Multilateral Investment Guarantee Agency) that guarantees non commercial risk for investors from member countries which invest their money in other member countries.

2. Portfolio Investment

Although the first Indonesia's stock exchange was established in 1912, it was only since 1987, following several deregulations, that the Jakarta Stock Market has become an active capital market. Market capitalization in the Jakarta Stock Exchange went up from Rp 3,657 billion* in 1989 to Rp 15,251 billion at the end of 1992. The number of issuers

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* Exchange rate 17 February 1993
US$1 = Rp 2,060.03

(stock and bond) has also grown rapidly from 90 in 1989 to 190 in 1992. This explosive growth has been the result of a number of deregulation packages enacted by the government in 1987, 1988, and 1989, which have encouraged the financial sector particularly banking and stock exchange to grow dramatically.

The deregulation of the stock market encompasses a wide range of aspects related to the operation of capital market including on listing, indemnity and trading regulations. In 1988, more deregulatory measures were announced and the most significant of these included the possibility of establishing new private exchange outside Jakarta, and the issuance of rules regarding insider trading. Following these measures, the first stock exchange outside Jakarta was opened in Surabaya in June 1989. One very important aspect of the deregulation was related to the participation of foreign portfolio investors in the capital market. The market which was closed in the past is opened to foreign investors and since 1987, they are allowed to purchase stocks up to 49% of listed shares traded.

The government's earnest intention to encourage foreign investor participation in the capital market was proven most recently by the issuance of the Government Regulation No. 70/1992 last year that allows foreign investors to purchase up to 49% of the shares of local banks listed on the Jakarta Stock Exchange as in the case of other listed companies. The development of foreign investors participation in the Jakarta Stock Exchange for the last four years can be seen more clearly in the Attachment Table 1.

III. Assessment and Evaluation

1. On Foreign Direct Investment

During the 1970s, except in 1975 when the approved value reached $1,145 million resulting from the huge investment in Asahan hydroelectric and aluminum project, the average value and number of FDI projects approved was $314 million and 39,

respectively.

During the 1980s, the number of FDI approved projects as well as value increased significantly compared with the 1970s. In 1980, FDIs approval reached $1,076 million with 21 projects, and in 1991 FDI approvals increased dramatically reaching $8,778 million with 376 projects.

Between June 1967 and September 1992 (cumulative figure), the Government approved 2,350 projects with total proposed investment of $59,033.7 million. With regards to the implementation of FDIs, the cumulative figure between June 1967 and September 1992 amounted to $20,141.9 million or 34.1% of total investment approvals in the same period. The number of realized projects reached 1,390 or 59.1% of total approved FDIs projects.

The distribution of investment origin showed that during the period of 1967 up to September 1992, the largest investment in terms of value and number of projects has been coming from Asia. The number of approved projects was 1,489 with value of investment reaching $27,059 million or 45.8% of the total approval value. The dominant countries were Japan and NIEs (South Korea, Taiwan, Hong Kong and Singapore) with the total value of $12,570.6 million and $13,910.3 million, respectively.

The second major investment origin was Europe with 379 approved projects amounting to $8,602.5 million or 14.6% of the total approval value of FDIs in Indonesia for the same period. The dominant countries are the Netherlands, United Kingdom and Federal Republic of Germany with the total value of $2,215.0 million, $2,167.4 million, and $1,859.1 million, respectively.

The third was North America with 183 approved projects in the amount of $2,501.5 million or 4.2% of the total approval value. The United States was the dominant country with total value of investment approval of $1,851.1 million.

In terms of numbers of approved projects, investment from the NIEs between 1967 and September 1992 accounted for 39.4% of the total number of projects.

The amount of Taiwanese investment approval rose drastically from $18 million 1986 to $618.3 million in 1990 and to $1,056.5 million in 1991. South Korea has also begun to play an important role in recent years. Investment approval which in 1985 was only $58.7 million has grown rapidly to reach $722.9 million in 1990.

In terms of implementation (realized investments), between June 1967 and September 1992, Japan was the largest investing country, accounting for 33.6%, followed by NIEs which accounted for 21.1%, and the United States for 8.14%.

Regarding the distribution of field of investment, for the period of 1967 up to September 1992, it was found that the largest planned investment was in the industrial sector both in number of total projects as well as in total value. The number of approved projects in this field was 1,551 projects. The dominant sub-sectors were chemical ($12,220.4 million), metal products ($5,292.3 million), basic metal ($4,389.6 million), paper ($4,020.3 million) and textile ($4,000.3 million). Next to industrial sector was the service (tertiary) sector with 531 approved projects amounting to $17,181.6 million in value or 29.1% of the total approved value of FDIs. The dominant sub-sector was hotel industry with total value of $6,811.0 million. Furthermore, 9.5% was invested in the primary sectors consisting of 268 projects and with $5,632.0 million in the value of investments. The dominant sub-sector was mining with the total value of $3,630.8 million.

In the manufacturing sector, Japanese investors have invested most heavily in basic metal, metal products, and chemical. American FDI has been mainly involved in the chemical and basic metal. FDI from Hong Kong has been mainly involved in the paper products, while the Taiwanese have been active in textile and apparel products, the Korean in chemical and textile, and the Netherlands and Federal Republic of

Germany in chemical.

Out of the approved investments that were implemented within the June 1967 and September 1992 period, realized investments in the manufacturing sector was the largest amounting to $13,626.5 million (67.7%), followed by primary sector (19.4%), and tertiary sector (12.9%).

The rapid increase in FDI in Indonesia during the 1980s can be attributed to the following major factors:

(a) The appreciation of the Yen and currencies of the four East Asian Newly Industrialized Economies (NIEs) combined with the rising labor costs in these countries had forced relocation of certain industries to other countries including Indonesia.

(b) Indonesia's relatively large domestic market and low labor cost.

(c) abundance and variety in natural resources.

(d) the stability of Indonesia's political environment and the government's achievements in maintaining economic stability and in ensuring a domestic environment which encourage private sector participation in the development process.

(e) the generally positive policy stance towards foreign direct investment taken by the Indonesian government.

2. On Portfolio Investment

Government economic policies in the 1960s and early 1970s did not create an environment conducive for stock market development. Financing was mostly provided by the State Banks with subsidized interest rates. In an effort to curtail capital flight, in 1968 the Government eliminated income tax on interest income received from time deposits. Even though the Jakarta Exchange was reopened in the 1970s and several new companies listed during the period but due the fact that interest income was tax free people did not have the incentive to invest in stocks.

After the deregulations, a new era in the Indonesian stock market began and an increasing number of new companies went public. After being in place for 20 years, in 1988 the Government revised its policy on income received from Bank deposits by imposing a 15% tax on bank time deposit income. This was perhaps one of the most important factors that encouraged the development of the market and this has made investment in shares a more attractive option for local investors. The further opening of the market to foreign investors in 1989 was another factor that contributed to the emergence of the market. The new legislation allowed foreigners to purchase up to 49% of all companies' listed shares, including the shares of joint venture companies but excluding Banks. In the past, foreigners could only purchase shares in 8 out of the 24 listed companies at that time.

The participation of foreign investors in the market has no doubt been one of the most important factors in the revival of the stock market and the future development of capital market in Indonesia is also very much dependent upon the attitude and perception of foreign investors toward the market.

Although the Indonesian Capital Market has been much more developed today than several years ago, there are still much more to be done before it can function most effectively to serve the needs of Indonesia's growing economy. Like any new market, the Jakarta Stock Market has to strengthen itself in

many aspects before it can develop to become an important market in the region. Among the most important aspects that need attention are the need to encourage the issuers to commit to a fuller disclosure, setting up investment funds, encouraging the investment manager and investment advisor, improving control on the increasing number of issuers, setting up clearing, settlement and depository companies and developing secondary market for bonds.

Law enforcement to reduce fraudulent practice in trading as well as developing professionalism of all parties involved in the Exchange are also important factors that will allow the capital market to operate more efficiently.

IV Actions Recommended

For host governments:

1. Simplifying the regulation, measures and investment application procedures.

2. Simplifying the import and export procedures in order to support the free trade based on the GATT articles.

3. Improving the infrastructure facilities which urgently needed by investment activities.

4. Maintaining national and political stability.

For home governments:

1. Providing a reasonable lending interest rate for investment activities in developing countries.

2. Eliminating any discriminating measures or restriction on developing country basis.

3. Enhancing promotional activities concerning investment in developing countries through seminar, workshop, investment mission and business meeting.

4. Opening domestic market widely for the products of developing countries.

5. Providing incentive and investment insurance for companies investing in the developing countries.

6. Supporting transfer of technology to developing countries with a fair and reasonable royalty/fee.

7. Providing appropriate facilities and financial support for conducting education, training and courses for improving human resources quality of developing countries.

8 Providing financial support for the improvement of physical infrastructure facilities in developing countries such as road, port, electric power and telecommunication. This support in turn will be beneficial for FDI activities to minimize investment cost.

For the international institutions such as The World Bank, IMF and IFC

1. Providing financial support as well as expertise to study methods and strategies that can effectively attract more FDI to developing countries.

2. Providing sufficient facilities for training, education and courses to upgrade the ability and capability of developing countries' officials in investment management.

3. Supporting financially the effort to develop and upgrade the physical and non-physical infrastructure facilities in developing countries.

Attachment

Table 1

Foreign Investors' Participation in Jakarta Stock Exchange

Period	Number of listed shares	Foreign portion	Foreign owned	Available for foreign investors
1989	438,956,540	183,403,135	43,974,015	139,429,120
1990	1,779,909,594	830,321,961	442,574,845	387,747,116
1991	3,729,454,279	1,658,826,430	856,492,920	802,333,510
1992	6,253,916,082	3,056,025,940	1,504,262,228	1,551,763,712

The Experience of Developing Countries in Attracting Foreign Private Investment - The Case of Malaysia

I. Introduction

Foreign investment has played an important role in the economic development of Malaysia. During the Colonial days, there was substantial British capital in rubber plantations and tin mines. The British also built roads and railways mainly to transport rubber and tin to the ports for exports. In those days, foreign investment was mainly in the form of direct investment.

After independence in 1957, foreign investment, while remaining concentrated in rubber and tin production, began to diversify into other agricultural crops and industries, including processing of raw materials. These investments were still in the form of direct investment. Portfolio investment was practically non-existent.

In the late 1960s and early 1970s, large multinationals invested in import-substitution industries which were mainly simple consumer and intermediate goods industries. From the mid-1970s until 1983, Malaysia saw a substantial increase in foreign direct investment in petroleum and gas related industries as well as manufacturing industries, mainly in electronics and textiles.

The world-wide economic recession experienced in 1985 began to take its toll on the flow of direct foreign investment in Malaysia. As a result, there was a noticeable decline in the two years that followed. However, following the move by the Malaysian government to liberalize equity ownership in 1986, direct foreign investment

rebounded in 1988.

In quantitative terms, on average, the annual net inflow of foreign investment into Malaysia was between RM200-300 million[1] from 1960s to early 1970s. From the mid-1970s to early 1980s, the annual net inflow increased to an average of about RM1 billion, largely due to a higher investment in oil and gas related to the electronics industries. It reached a high level of RM3.3 billion in 1982 before easing during the recession years that followed. The net inflow rebounded to RM1.9 billion in 1988 and accelerated to RM4.5 billion in 1989, RM6.3 billion in 1990, and RM9.6 billion in 1991. For 1992, the net foreign investment was estimated to be RM10.4 billion.

In Malaysia, direct foreign investment accounted for 31% of the country's private investment in 1991. This shows the increasing importance of direct foreign investment, as in 1970 it constituted only 24% of private investment.

The Malaysian capital market, which until the early 1960s, was practically non-existent, comprises of three components. These are the equity market, the Malaysian Government Securities market (MGS), and the private corporate bond market (PDS) which covers corporate bonds and promissory notes. The early 1960s saw a gradual takeoff for the capital market, which, however, was still confined to the local players. Initially, the Government concentrated on the development of the MGS market while allowing

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1 The exchange rate as of February 17, 1993 was US$1 = RM2.6265

the equity market to function freely in market-oriented environment. At that time, the development of private debt securities was still lagging. It was only towards the middle of the 1970s that capital market investment in private debt securities began to experience a more substantial increase, as the economy grew and expanded its industrial base.

In terms of regulatory and legal framework, the securities industry is governed by the Securities Industry Act (SIA) 1983 and the Companies Act 1965. Both Acts seek to develop and manage a healthy capital market and economy as well as to ensure the protection of investors.

The Companies Act 1965 provides for greater disclosure on company operations and capital structure to protect the investing public and promote the growth of a well-informed and discriminating body of investors.

The Securities Act 1983 replaces the previous 1973 Act. In addition to the objective of ensuring safeguards for the proper listing of and dealing in securities, the licensing of share dealers and the maintenance of proper and adequate records, this Act provides the enforcement and investigative power to the Registrar of Companies.

Until 1993, Malaysia had no securities commission. There are various bodies that regulate different aspects of the capital market. These bodies are the Capital Issues Committee (CIC), the Registrar of Companies (ROC), the Panel on Take-overs and Mergers (TOP), the Foreign Investment Committee (FIC) and the Kuala Lumpur

Stock Exchange (KLSE).

The CIC was formed in June 1986 to ensure the orderly development of the capital market by regulating the issue of securities by public limited companies and listing of such securities on a stock exchange in Malaysia. The Securities Industry Act 1983 gives the CIC the legal backing to act as a consultative body to advise the Minister of Finance and the ROC. All public limited companies incorporated outside Malaysia intending to issue or offer for sale their securities on a stock exchange require the prior approval of the CIC.

The ROC administers the Companies Act 1965 which governs the affairs and conduct of companies registered under it. Under the Securities Industry Act 1983, the ROC is empowered to issue, renew or reject licenses to dealers, investment advisors and their representatives.

TOP is a body created in 1986 under the Companies Act to administer the Malaysian Code on Take-overs and Mergers. This is to ensure that all take-overs are conducted in an orderly manner and to protect the interest of minority shareholders.

In 1974, FIC was established to implement the Government's guidelines on regulation of acquisition of assets or interests, and mergers or takeovers of companies and businesses by foreign investors. The guidelines established were aimed at restructuring the pattern and structure of ownership and control of the corporate sector, reducing imbalances in the distribution of corporate wealth, while at the same time encouraging private

investment that contributes to the development of the economy and to ensure consistency with the objectives of the New Economic Policy.

The KLSE was incorporated as a public company limited by guarantee in July 1973. It is a self-regulatory organization and has a set of rules which govern the conduct of its members in securities dealings. It is also responsible for the surveillance of the securities market and the enforcement of its listing requirements.

Malaysia has maintained a liberal system of foreign exchange control since 1973. The inflow of funds into Malaysia is freely permitted, while payments to non-residents for any purpose including the repatriation of profits, fees royalties and proceeds from the sales of assets in Malaysia by foreign investors are freely permitted.

As a result of these measures, the volume of portfolio investment has shown a significant increase. In 1988, private debt securities amounted to RM0.6 billion or constituted only 5.8% of the Malaysian capital market. It showed a significant increase in 1991 , reaching the level of RM2.4 billion which constituted 24% of the capital market. Similarly, the equity market also showed a substantial increase, reflecting its increasing importance in the capital market. In 1988, the equity market amounted to RM1.0 billion or 9.6% of the capital market. It shot up to RM4.4 billion in 1991, increasing its market share to 44%. The increasing role of the private and debt securities means reducing the importance of

the MGS in the capital market. In 1988, MGS amounted to RM7.5 billion or 72.1% of the capital market. In 1991 its amount fell to RM3.2 billion which constituted only 32.0% of the capital market. The percentage of foreign equity also increased. In 1989, the Kuala Lumpur Stock Exchange ranked 16th in terms of foreign equity turnover. This is a good indication of the level of international investment in Malaysian stocks.

Several other initiatives were taken to improve the capital market. Among the most important is the separation of the Kuala Lumpur Stock Exchange (KLSE) and the Stock Exchange of Singapore (SES) from January 1990. This separation means the delisting of 182 Malaysian-incorporated companies from SES and would reduce the vulnerability of KLSE to developments in SES. The split further facilitates the regulation and monitoring of activities of the KLSE and the companies listed.

The setting up of a central depository system in KLSE in 1990 has helped to enhance settlement and custodial arrangement with minimized risk. The system introduces a scripless transaction which promotes more efficient handling of the securities business.

With globalization of the capital market, the Government realized a need for a more sophisticated private debt securities market. A private credit rating agency, Rating Agency of Malaysia (RAM) was set up to provide credit ratings for corporate bonds and other PDS. Its rating was initially voluntary, but from June 1992, it was made mandatory.

The Government realizes the need to rationalize and streamline the regulatory framework for the capital market. In early 1993, a single regulatory authority, the Securities Exchange Commission, was set up to promote development of the capital market. The Commission is expected to ensure a more efficient, consistent and effective regulation of the securities market.

II. Policy Measures Taken to Attract Foreign Investment

Malaysia's success in attracting direct foreign investment is mainly due to a mixture of fiscal, trade, investment and financial policies and measures, provision of infrastructural facilities, political stability, liberal exchange control, educated and easily-trainable labor and abundant raw materials. These policies and measures were aimed at enhancing the role of the private sector as the engine of growth of the economy. The manufacturing sector has been identified as one of the sectors that could provide the impetus to growth. Realizing this, the need to increase competitiveness and raise industrial efficiency, to promote exports and encourage entrepreneurial initiative, as well as to balance development of the manufacturing sector was emphasized. Apart from the manufacturing sector, agriculture and tourism were also considered essential in the country's economic development.

Clear and transparent industrial and foreign investment policies were introduced by the Government. These goals, targets, policies and strategies on industrial development were clearly spelt out in various economic blueprints and documents such as the

Fifth Malaysia Plan, (1986-1990), the Sixth Malaysia Plan (1991-1995), the Second Outline Perspective Plan (1991-2000) and Vision 2020 by which time Malaysia hopes to become a developed country. In addition, there was the Industrial Master Plan (IMP) 1986-1995 which calls for an outward-oriented industrialization, with particular emphasis on resource-based industries, diversification of non-resource-based industries, and promotion of selected heavy industries. All these documents reflect the strong commitment of the government which is translated into concerted efforts in spearheading the industrialization process.

The IMP is not implemented in isolation but is supplemented by an improved incentives system, and the modernization and rationalization of the industrial sector supported by technology and manpower development.

In 1986, the Government introduced the Promotion of Investments Act to replace the Investment Incentives Act of 1968 and also amended the Income Tax Act of 1967. This Act and amendment introduced a wide range of tax incentives for the manufacturing, agriculture and tourism sectors. These include tax holidays, investment tax allowance, accelerated depreciation allowance, reinvestment allowance and allowance for exports.

Other fiscal incentives were also introduced during the second half of the 1980s. These incentives include the reduction of corporate tax to levels that are competitive with other ASEAN countries, which in 1993 has been reduced further to 34% while the development tax of 2% was entirely abolished. Other incentives are

double tax deduction for approved training; provision of incentives for research and development and skills training; incentive packages for the promotion of small-scale industries such as granting of pioneer status, reinvestment allowance of 50% and full exemption from custom duty on raw materials or machinery not available locally; and the provision of incentives for research and development and skills training such as revenue expenditure incurred for approved research is eligible for double deduction, industrial buildings used for approved research are eligible for an initial allowance of 10% and an annual allowance of 2% and plant and machinery used for approved research are eligible for capital allowances. In addition, incentives are provided for overseas investment and businesses such as export credit refinancing scheme, abatement incentive for exports, double deduction of export credit insurance premium and double deduction for promotion of exports. Incentives for the establishment of operational headquarters are also provided, which include concessionary rate of tax at 10% on management fees arising from services rendered, on royalties arising from R & D work carried out in Malaysia and tax exemption on dividends received from investments made in subsidiary and associate companies. Incentives are also given for tourism industries such as pioneer status, investment tax allowance and industrial building allowance.

Apart from that, Malaysia also maintains liberal exchange control regulations. Foreign investors operating in Malaysia are permitted to borrow both domestically and abroad. No formal

approval is required if the borrowing of Malaysian Ringgit from the domestic financial market does not exceed RM10 million. For borrowing in foreign currency from abroad which exceeds RM1 million, the permission of the Central Bank is required. Malaysia allows free remittance of profits and dividends in foreign currencies generated by foreign companies. This liberal exchange control policy has played a crucial role in attracting foreign investments to the country.

An accommodative monetary policy where price is stable and inflation is low in the growing economy serves as an extra point in attracting foreign investment.

Malaysia also has a liberal and transparent expatriate employment policy. This allows foreign companies to bring in the required personnel in areas where there is a shortage of trained Malaysians. Foreign companies are also allowed certain "key posts" to be permanently filled by foreigners. A company with foreign paid-up capital of more than $2 million is allowed five expatriate posts including key posts. Additional posts are given if necessary. For executive posts which require professional qualifications and practical experience, expatriates may be employed up to a maximum of 10 years, with the condition that Malaysians are trained to eventually take over the posts. For non-executive posts, the same conditions hold with a maximum employment of 5 years.

To supplement this, a comprehensive review of the labor laws was undertaken by the Government in order to make the employment of

the local labor force cost-efficient. This, coupled with the availability of an educated and trainable labor force, made investment in Malaysia more attractive to foreign investors.

The Malaysian Industrial Development Authority (MIDA), which was initially established to promote foreign investment in the manufacturing sector, was further given an enhanced role as a center for coordination of investment from October 1988. With this enhanced role, MIDA serves as a one-stop agency for manufacturing activities as well as for applying for tax incentives on integrated agricultural, hotel and tourism projects. This rationalization process has made it easier for potential foreign investors to seek the necessary approval or assistance, as it succeeded in simplifying procedures and further reducing administrative bottlenecks. In addition to regional offices in all the thirteen states in Malaysia, MIDA also has fourteen overseas offices to serve foreign investors in countries such as Japan, U.S.A., Taiwan and Hong Kong.

A Technology Park was set up with the aim of promoting more research and development and greater private sector investment, and offering of competitively-priced industrial estates to investors. Foreign investors are also provided with twelve Free Trade Zone (FTZ) facilities located throughout the country. Companies outside FTZs are accorded Licensed Manufacturing Warehouses. These companies are subject to minimum customs formalities and are eligible for duty free import of raw materials, component parts and machinery.

Another important factor that contributes to high inflow of foreign investment is the high quality of infrastructure facilities such as a good network of communications, transport and utilities. The Government has undertaken new initiatives to keep infrastructure development in step with the rapid development in the industrial sector. Under the Sixth Malaysia Plan (1991-1995), the Government has allocated a substantial investment of approximately RM26 billion to finance the upgrading of transport and communication infrastructure.

Measures were also introduced to increase competitiveness through the lowering of business cost. This was done by the lowering of electricity rates and international telephone and telegraph rates for selected activities.

In addition, many areas of Government services, public sector projects and corporations including highways, telecommunications, postal services, electricity, the national airline, shipping companies and heavy industries were privatized in an effort to promote business-like efficiency and introduce competitiveness.

In terms of portfolio investment, the Government in 1986 adopted a liberal policy on foreign equity participation. Ownership permitted to be held by foreign investors depends on the proportion of products being exported. Foreign investors are allowed to own up to 100% equity if they export 80% or more of their product. For a company that exports 50% or more but less than 80%, foreign ownership of up to 100% is allowed if the fixed assets is RM 500 million or more, or implements projects which have

at least 50% value added. The 100% equity ownership is also allowed for projects in manufacturing and agriculture where local participation cannot be found, or where the products do not compete with those manufactured for domestic market.

The level of foreign equity for other export-oriented projects are determined depending on factors such as the level of technology, spinoff effects, size of investment, location, value-added and the utilization of local raw materials and components.

The liberal foreign equity participation level has led to an upsurge in the foreign portfolio investment flow into Malaysia, particularly from 1986 onwards.

The tax system also encourages foreign investment. The Malaysian tax regime does not include capital gains tax. Dividend income is normally assessed in the country in which the recipient resides and exempted or partially exempted in the source country. There is also no separate tax on dividends.

The Government also continues to widen and deepen the capital market in an effort to attract foreign portfolio investment. This includes the corporatization of the stockbroking industry which became effective in October 1987. It was aimed at improving the financial strength of the industry, injecting expertise and professionalism as well as generating greater international interest in dealing on the Kuala Lumpur Stock Exchange. Recently, the Government allowed foreign stockbroking companies to increase their equity participation in local stockbroking companies from the previous level of 30% to 49% if the foreign stockbroking partners

can demonstrate that they can contribute positively to the business of the local stockbroking companies. With the increase in foreign participation, the stockbroking companies are expected to be more aggressive in projecting their image abroad in order to capture a larger share of foreign business and further promote the Malaysian stockbroking industry.

Besides the domestic stock exchange securities, foreigners can also invest in Malaysia through country funds listed in overseas stock exchanges. The Malaysia Fund listed in New York in May 1987 made a total public offering of US$87 million. Another fund is the Malaysia Growth Fund launched in Japan in April 1989. Another fund is the multi-country fund, such as the ASEAN Fund. These funds offer important conduits for foreign portfolio investment in Malaysia.

The Malaysian authorities also work to ensure an efficient financial settlement system for processing interbank fund transfers and customer-initiated payment instructions as well as for affecting and recording the clearing of transactions in Government papers, Central Bank certificates and the Cagamas bonds. This is an important precondition for the development of a broader and deeper secondary market in securities, especially in the development of an active retail market. The settlement systems include the Securities Clearing Automated Network Services, the Fixed Delivery and Settlement System, the Electronic Transfer of Fund and Securities System, the Interbank Funds Transfer System and the Scripless Securities Trading System. Participation in these

systems is to be done through direct members or indirect members. Presently there are 94 institutions which are either direct or indirect members. Of this, 68 are appointed Authorized Depository Institutions which have the statutory obligation to maintain a separate customers' account for each client and to provide customers with an acknowledgement receipt every time there is a transfer of securities and a monthly statement of account with respect to their investments.

Several other measures were also undertaken by the Kuala Lumpur Stock Exchange (KLSE) to streamline and improve the trading system. These include the establishment of a clearing house, the installation of the real-time share price reporting system and the adoption of a new and up-to-date KLSE's composite index in 1986 to replace the KLSE industrial index to reflect movements in share prices.

In terms of regulatory framework, several amendments were made to the SIA between 1987 and 1989 to create a healthy investment climate by providing better protection for the investing public and generally provide for the ROC with wider powers to administer the Act. The CIC also made various revisions of its guidelines. Greater emphasis was given to qualitative criteria which takes into account the company's management, sectoral/industrial analysis of its business and its degree of vulnerability.

More importantly is the setting up of a single regulatory body - the Securities Exchange Commission in 1993 to further enhance and streamline the regulation of the securities market. With a single

body overseeing the securities market, its development is expected to accelerate further.

Another important factor is the political stability that Malaysia has to offer. The strong government that has been in power since independence and its transparent policies provide a sense of security and guarantee continuity in economic policies; they have proven to be a strong point in attracting foreign capital into Malaysia.

III. Assessment and Evaluation

It is not easy to evaluate and assess the effectiveness of the various measures taken by Malaysia in order to attract the flow of direct foreign investment. This is because all the measures taken were meant to complement each other. These measures therefore cannot be assessed in isolation.

There are three major important areas of policies and measures that are considered crucial in achieving the success of Malaysia, especially in attracting foreign investment. First, a conducive economic environment with a well-developed infrastructure and an educated and easily-trainable labor force make foreign direct investment relatively easy. Coupled with attractive and competitive tax and other incentives as well as relatively stable prices, Malaysia offers a lot of opportunities to potential foreign investors.

The second important factor is the concerted efforts and commitment by the Government in spearheading the industrialization

process. The transparent industrial policies which were clearly spelt out, made it easier for foreign investors to understand and plan ahead for the long-term investment.

The third factor is the political stability that Malaysia has to offer. This reduces political risks to potential foreign investors, who only have to worry about business-related risks.

In terms of portfolio investment, the continued improvement and modernization of the stock exchange market is the key factor that contributes to the Malaysian success.

In essence, the success of Malaysia in attracting foreign investment revealed the importance of fostering and maintaining the right economic and political environment, adequate physical infrastructure and an educated labor force. All the measures taken were aimed at promoting exports, encouraging entrepreneurial initiative and achieving balanced growth of the manufacturing, agricultural and tourism sectors.

IV. Actions Recommended

The actions recommended to be taken by the host government, the home government and the multilateral institutions to further promote or catalyze direct foreign investment are numerous.

For the host government, economic policies, such as the setting of exchange rates, the setting of the prices of inputs including utilities and the provision of infrastructural and support facilities play an important role in influencing the flow of foreign direct investment. A developed banking system that is

able to facilitate the raising of funds for investors and the movement of foreign currency is also important. The establishment of a one-stop investment center, that handles all the bureaucratic procedures, can help to simplify procedures and reduce delays.

The level of assistance offered to the export sector could determine the attractiveness of the host country to export-oriented investments. The establishment of export processing zones that facilitate investors to operate under free-trade conditions also encourage export-oriented operations. Attractive incentives and financing facilities for exports also play an important role.

Regulations and policies such as those relating to foreign equity ownership; expatriate employment; taxation; foreign exchange and remittance of earnings; price controls; performance requirements such as local content and export; sector-specific limitations and incentives could also influence the flow of FDI into the host country.

Policies regulating the work force, such as laws on trade unions, laws on the employment of expatriates, laws on hiring and firing, and wage setting are also important.

Bilateral investment guarantee agreements and double taxation agreements are also measures undertaken by host governments to assure foreign investor confidence.

The existence of foreign investors experiencing successful operations in a host country can, in itself, be a stimulant for further investment both from existing and from new investors. Existing foreign investors in the host country can also be

instrumental in relocating their suppliers or subsidiaries from the home country to other investment destinations.

All the above measures should be seriously considered by the host governments in an effort to attract foreign investment. While it is recognized that the economic and political environments may differ between countries, adjustments and adaptations can be made to suit the local conditions but it must ensure that the incentives and facilities offered are attractive and competitive.

For the home countries, macro-economic policies are important factors influencing the outflow of FDI. These policies have major domestic economic effects and could influence certain factors which could affect foreign investment flows. These factors include the relative return on capital investment at home and overseas; the ability to export capital out of the home country; and the extent that foreign investment is intended to supply the home-market or the degree of protection in the home country. Studies have indicated that protection would be the "most damaging policy by industrialized countries hampering the flow of FDI to developing countries". For example, US restrictions on textile imports have restricted US investment flows in this sector in developing countries. On the other hand, preferential trade agreements between industrialized and developing countries, such as the US Caribbean Basin initiative, can enhance investment flows. Exchange rate movements have also affected levels of foreign investment. For example, the upward movement of the yen, beginning in 1985, accelerated the process of Japanese export-oriented investment in

Asia.

The removal of restrictions on movement of investment funds by the home countries and the conclusion of non-discriminatory double taxation agreements and tax sparing legislation are also important in enhancing foreign investment in developing countries. Investment guarantees between home and host countries are also important in assuring foreign investor confidence.

These are some of the measures that home countries could seriously consider if they are sincere in encouraging direct investment in developing countries.

For the <u>multilateral institutions</u> (e.g. IMF, the World Bank Group, UNIDO, ESCAP etc.), their role in the promotion of direct investment flows to developing countries is also important, particularly at this point of time when many developing countries are rapidly liberalizing their economies to attract foreign investors.

These institutions should help to promote or catalyze foreign direct investment flows by supporting investment promotion programs of host countries. Support could be given in the areas of providing general information; sponsoring investment promotion missions to enable investors to gain first-hand knowledge of investment possibilities and to make direct business contacts; support project feasibility or sectoral studies; and support for foreign investment advisory services to be set up in the host country to help identify investment opportunities for home country.

To conclude, all the three parties: the host country, the

home country, and the multilateral agencies, have to play their respective roles effectively in order to facilitate the flow of capital from the industrialized countries to the developing countries.

Appendix

Foreign Investment in Approved Projects by Country 1984 - 1992
(RM Million)

	1984	1988	1989	1990	1991	1992
Australia	8.4	25.5	29.8	54.3	413.9	2119.5
Canada	-	5.2	16.3	81.0	63.4	22.3
China	-	-	11.3	9.7	399.5	9.5
Hong Kong	21.4	298.4	352.1	375.0	600.6	83.5
Indonesia	-	23.2	105.4	1083.3	1242.9	480.2
Japan	199.0	1222.0	2690.4	4212.6	3796.5	2635.6
Korea	22.7	41.8	188.9	650.4	1818.7	99.4
New Zealand	7.7	2.5	-	26.3	60.5	1.5
Philippines	4.5	-	0.3	40.6	2.2	18.3
Singapore	100.4	419.6	914.7	895.3	1127.4	440.5
Taiwan	31.9	829.6	2159.9	6339.1	3607.2	1505.8
Thailand	8.9	57.5	8.9	5.3	14.6	1.5
USA	37.3	535.2	320.8	567.3	1798.9	3298.2
EC	90.9	908.5	1255.1	1128.4	1264.9	6580.2
Others	184.8	509.0	1128.4	2160.5	1166.6	428.1
Total Investment	718.1	4878.0	8652.7	17629.1	17377.8	17724.1

Source: MIDA, 1993

THE EXPERIENCE OF DEVELOPING COUNTRIES IN ATTRACTING FOREIGN PRIVATE INVESTMENTS - THE CASE OF SINGAPORE

I. INTRODUCTION

The key element in Singapore's rapid industrialization has been the large inflow of direct investment into export-oriented manufacturing industries. Through their investments in Singapore, multinational companies hope to develop their respective Singapore operations as integral parts of their global market and development programs. Their aims are:

(i) to manufacture parts and components to supply parent companies in their home countries and subsidiaries in various parts of the world;

(ii) to produce finished products in large volume for international markets;

(iii) to manufacture capital equipment, intermediate products and chemicals for the regional market especially for offshore oil exploration, mineral, agricultural and forestry development, and construction projects;

(iv) to use Singapore as the "launching site" for establishing branch manufacturing operations in the region;

(v) to use Singapore as an international servicing and warehousing centre for the quick supply of spare parts and after-sales service, and for training dealers, technicians and maintenance and repair crew in Asia; and

(vi) to set up engineering, design and consultancy services, ranging from civil engineering, construction and industrial plant design and fabrication to geophysical research and computer software to serve the region.

Manufacturing investment (excluding petrochemicals) averaged S$1.7 billion [1] a year in 1980-84, of which two thirds were foreign controlled enterprises. In the early part of the 1980s, Singapore was very dependent on oil and shipbuilding but is now increasingly focusing on computers and electronics. For 1986, the level of investment commitments in manufacturing was S$1.4 billion, of which S$1.2 billion was foreign origin. This increased to S$1.7 billion in 1987, of which S$1.4 billion was foreign origin. In 1988, investment rose by 15.2 percent, to over S$2 billion, of which nearly 83 percent was foreign origin. Investment fell slightly in 1989, to under S$2 billion, of which 83 percent again came from abroad. A sharp increase in foreign investment pushed up total investment to S$2.5 billion in 1990, of which less than S$300 million came from local sources. As in previous years, the largest share of investment (44 percent) was in the electronics sector. The second largest was petroleum (15 percent of the total). In recent years, the share of EC countries in total foreign investment has generally been rising, reaching 32,3 percent of all foreign investment in 1989, compared with 20.4 percent five years earlier. However, in 1990, EC investment fell back, accounting for only 17.8 percent of the total, and the United States again became the major investor. It committed over S$1.0 billion, or 47.6 percent of the total, followed by Japan with S$0.7 billion.

Singapore's privileged geographical position, strengthened by the development of communication infrastructures, has also favored the emergence of dynamic financial activities linked to entreport trade and quickened by the local branches of London-based banks. Based on the experience bequeathed by Britain, Singapore became the relay-station of the financial market: a regional centre for the supply and demand in capital for the Asian countries, and a place for the exchange of American, Arabic, Asian and European capital seeking investment in zone outstanding in rich natural resources.

Financial sector has also been playing a crucial role in the economic development of Singapore. The development of its financial markets and institutions owes much to the role it has been playing as the most important international trading center in the region.

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[1] The exchange rate as of February 17, 1993 is US$1 = S$1.6427

The present advanced status of the Singapore's financial market was originated in the late 1960s when the government recognized that the financial sector could become an independent growth sector, over and above its service to the commerce and industry sectors. A strategy to develop Singapore into an international financial sector was formulated, encompassing legislative, fiscal and administrative measures. This strategy has been implemented successfully and in keeping up with the changes and developments in different parts of the world, Singapore's financial sector has used the advances in computer and telecommunication technologies to make the market more competitive and to become an integral part of the global financial and capital markets.

Over 1978-88, the financial sector was the fastest growing sector in the economy and its contribution to GDP more than doubled from 5.2 to 13.6 percent. In 1983-88, it was the second largest contributor to GDP, next to manufacturing which contributed 33.6 percent. Although the financial sector is not the largest employer, the financial sector has contributed significantly to employment growth. Since 1978, employment in the sector has grown at more than twice the rate for overall employment and by 1988, constituted 3.8% of the total employment.

II. POLICY MEASURES TO PROMOTE FOREIGN INVESTMENTS

From the experiences of investment promotion to Singapore, the following factors and policy actions have proven to be the most effective in attracting direct foreign investment.

1. Liberal Investment Policy

Singapore's policy towards foreign investment is characterized mainly by both its liberality and its consistency over the last decades. Foreign investors are allowed 100 percent foreign equity ownership, freedom to repatriate profits and freedom to bring in foreign skilled workers to operate their facilities. Investors are also given the freedom to make their own decision on the types of activities and industries to invest in Singapore.

2. Investment Incentives

In certain circumstances, the government offers tax incentives to attract investment projects which have higher level of risk or a long gestation period. However, these tax incentives merely serve to be an "icing on the cake". Generally, they are not the critical factor that influence corporate investment decisions.

3. Proactive Promotion of Investment

In 1961, the Singapore government established a one-stop agency, the Economic Development Board (EDB), to spearhead Singapore's investment promotion in manufacturing. To obtain direct access to leading international companies, the EDB maintains 16 overseas offices in the major investment catchment areas in the US, Europe and Asia.

The EDB also adopts a customer-oriented approach in investment promotion. This means understanding the needs of the companies. Singapore is trying to attract and meet such needs in terms of business environment, infrastructure provision and skills availability.

4. Political stability and Public Service Integrity

The feedback from foreign investors is that political stability is one of the critical considerations when deciding on an investment location. With political stability, businessmen can afford to make long-term investments with the assurance that their assets will be safe and will yield returns.

Investors also mentioned that the public service with integrity, and transparent laws will make it easier for them to deal with government departments without incurring extra hidden costs.

5. Business Support Infrastructure

The whole range of business-support infrastructure is also important to promoting foreign investment to Singapore. In the early 1960s, this meant ready-to-use factories in industrial estates which provided basic amenities so that companies could move in and start up operations quickly.

As the economy upgraded, infrastructure development extended into manpower training in specialized skills, modern international transportation and communication systems, and using information technology.

To facilitate the movement of freight and businessmen, Singapore continues to upgrade its infrastructure such as port, airport and the telecommunications system.

International schools have also been established to enable the children of foreign expatriates to be brought up in their native language and culture, so that they can be socially integrated with their society when they return home.

6. Comprehensive Manpower Development

In view of new products and shortening product life cycles due to technological advances, the Singapore workforce has to meet the changing skills requirements of industries and businesses. Therefore, several training programs are operated in cooperation with leading international companies to utilize their expertise and knowledge of technology trends.

This also means that Singapore must promote continuous training and re-training. An important vehicle through which continuous training is promoted is the Skills Development Fund. This Fund is financed through a levy on the salaries of workers earning less than $750 a month. It is used to finance training and re-training programs undertaken by companies.

In terms of portfolio investment, Singapore is one of the few countries in Asia with a fairly well-developed corporate securities market. This market provides an important avenue for domestic companies to raise long-term capital through the flotation of securities on the Stock Exchange of Singapore (SES).

The market has hitherto been dominated by equity securities. There have been relatively few public bond issues. From 1980 to 1988, a total of S$7,211 million was raised through 147 initial offerings and rights issues. In contrast, there were only 23 listed bond issues amounting to S$1,296 million. The majority of these were either convertible bonds or bonds with warrants or transferable subscription rights attached. The volume of funds raised dropped considerably with the recession in 1985-86 but rebounded strongly with the recovery in 1987.

At the end of 1988, there were 326 companies listed on the Main Board of the SES. Of these, 132 were incorporated in Singapore, 182 in Malaysia and the remaining 12 elsewhere. Total paid-up capital and market capitalisation of the listed companies amounted to S$32 billion and S$104 billion, respectively. Over the past decade, the SES ranked third in trading volume among stock markets in Asia.

In order for newer, medium-sized companies to tap long-term funds to finance their business expansion, a second securities market, known as the Stock Exchange of Singapore Dealing and Automated Quotation Market (SESDAQ) was opened in February 1987. This second market has helped these companies to attract some capital from abroad.

To further promote international securities trading in Singapore, the SES and the US National Association of Securities Dealers Automated Quotation (NASDAQ) established a link in March 1988. The SES was the first Asian stock exchange to provide an organised market for the trading of international Securities. Steps are being taken to establish linkages with other exchanges.

III. EVALUATIONS

Based on Singapore's experience, the important factors that attracted foreign investment are a liberal investment policy and sufficient incentives, business support infrastructure and well developed financial system, a trainable and educated labour force as well as political stability and the high integrity of the public service. Other factors that contributed to the growth of the financial sector are rapid economic growth in Singapore and the surrounding region, a high domestic savings rate and large foreign reserves, a strategic location, a well developed infrastructure and the availability of support services.

IV. ACTION RECOMMENDED

For the host government, the experience of Singapore shows that all the measures mentioned above should be emulated by other developing countries if real capital flow is to be encouraged.

There are three main areas where home government action can be most effective in stimulating capital flows to developing countries. The first is the absence of restriction on capital outflow. The second is that the home nation can conclude bilateral treaties in the areas of investment guarantee and double taxation agreement to facilitate outward investments. Thirdly, the government can explain and convince the trade unions that internationalization helps to improve the competitiveness of the country and will lead to job creation instead of factories closure.

For the multilateral agencies, they can play a catalytic role in further enhancing the flows of capital to developing countries.

For all the three parties, however, the actions for each to take would have to take into account factors which are specific to the host and home governments.

Investment commitments in manufacturing (S$ mn)						
	1985	1986	1987	1988	1989	1990
Local	232.4	253.4	295.0	349.6	333.3	266.8
Foreign	888.0	1,189.6	1,448.0	1,657.8	1,625.4	2,217.5
Total	1,120.4	1,443.0	1,743.0	2,007.4	1,958.7	2,484.3
Main applications of investment (%)						
Food & beverages	4.9	5.8	9.0	8.4	1.7	1.8
Paper & printing	2.9	2.5	1.4	3.6	4.8	3.1
Chemicals	4.6	12.6	2.5	7.5	12.0	12.1
Petroleum	17.0	8.0	7.0	-	14.8	15.3
Machinery (non-electrical)	11.2	14.3	5.4	9.0	6.7	7.1
Electrical machinery	...	9.0	7.3	4.8	4.0	4.0
Electronic products	...	27.0	40.8	41.8	35.7	44.2
Transport equipment	7.9	4.5	3.5	5.5	2.6	4.6
Other	17.9	16.1	23.1	19.2	17.7	7.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source : Ministry of Trade and Industry, *Economic Survey of Singapore*.

THE EXPERIENCE OF DEVELOPING COUNTRIES IN ATTRACTING FOREIGN PRIVATE INVESTMENT: THE EXPERIENCE OF THAILAND, INDONESIA, MALAYSIA, AND SINGAPORE

Summary

According to the experiences of some SEA Group countries, the following sets of recommendations can be made.

Policies and measures by the host government should aim to achieve the following objectives:

1. Favorable economic environment both in terms of physical aspect such as adequate basic infrastructure and services ie. financial system, investment services, liberal investment policy and general investment promotional measures, should be provided for.

2. Confidence for investors in terms of political stability and consistency of government policy should be created and fostered.

3. Skilled human resource and educated labor force should be developed.

Actions recommended for the home government in order to stimulate investment in developing countries should aim to achieve the following objectives:

1. Reduce the restrictions on capital outflow.
2. Lower protectionist stances.

These may be unacceptable to some developed countries, but on the other hand there are high profit and large return on investment from abroad, which can be fully compensated for capital outflows. Besides, developed countries will also benefit from cheaper import goods.

3. Develop long-term industrial and economic competitiveness.

For the multilateral institution, their role in the promotion of direct investment flows to developing countries is also important. The institution can be of assistance for both developing and developed countries. Developing countries should aim to create favorable economic environment. For developed countries, multilateral institutions should try to eliminate trade protectionist policies and argue for a decrease in capital outflow restrictions.

However, the increase of FDI's in South East Asia were triggered by the effects of the currency realignments in 1985, supported by the readiness of these four countries. It would be difficult to conclude that the policies and measures implemented by these countries alone were responsible for the success of attracting FDI's. Also, the location of these 4 countries in a region close to the Indochinese countries provided great business opportunities in the expanding Indochinese markets. All these factors discussed importantly affected the flows of foreign private investment to the four SEA Group countries.

PROMOTING THE PRIVATE SECTOR
UNITED KINGDOM'S EXPERIENCE OF FOREIGN DIRECT INVESTMENT

I. INTRODUCTION

In recent years there has been a growing realization across the world that the private sector holds the key to sustained and rapid growth. One of the clearest results of this shift in thinking has been the widespread and accelerating process of privatization. Over eighty countries have launched privatization programmes, and since 1980 over 2,000 state owned enterprises in developing countries have been privatized. The recent changes in the former centrally planned economies of Eastern Europe and the FSU have only underlined the fundamental importance of the private sector.

2. However progress in other areas has been slower. For example while in the major industrialized countries the private sector accounts for 90 percent of all investment, in developing countries the share is only 50 percent and in sub-Saharan Africa only a third. If the private sector, including privatized enterprises, is to play its crucial role in growth and development, this will need to change.

3. Private sector funds, domestic and international, must be the main means of financing private sector development. This paper considers the role that foreign direct investment can play in promoting the private sector. The ability to attract foreign direct investment has been a key factor in the development of the private sector and the economic success of both developed and developing countries. This paper describes the UK's experience as both a recipient and a source of foreign direct investment. But the focus of this paper on direct investment is not intended to minimize the importance of other sources of private sector finance - for example, portfolio investment is becoming an increasingly valuable vehicle.

4. Furthermore while the private sector should be the main means of finance, public sector financial institutions, multilateral and bilateral aid programmes can all play facilitating and catalyst roles in helping the private sector develop. However their roles must be carefully defined to ensure that public finance is not crowding out, replacing or distorting the effective use of private finance.

II. UK EXPERIENCE OF FOREIGN DIRECT INVESTMENT

5. Foreign direct investment (FDI) is playing an increasingly important role in the workings of the world economy (Graph 1). Following the end of the recession of the early 1980s in the industrial countries, FDI grew particularly strongly, very much faster than during the cyclical up-turns of the 1960s and 1970s. Average growth in the up-swing was over 20 per cent a year in real terms, about four times faster than the growth of world trade. While the deregulation and liberalization of service industries has been an important factor in the OECD area, there is a general consensus that, cyclical fluctuations apart, this increased prominence of FDI flows will continue.

6. The UK has a particular prominence with respect to FDI flows. (Graph 2). It remains the second largest recipient of inward flows after the USA, and its share has been rising during the 1980s. It is also the world's

second or third largest overseas investor, alongside the USA but behind Japan.

UK as a beneficiary of foreign investment

7. The UK has had a long record of attracting foreign investment (see Box II). In the 1950s and the 1960s this was mainly from the US; many US multinationals are now seen as UK companies. In the last ten years alone the UK has received on average some $12 billion every year in direct investment - in 1989 and 1990 the figures were $28 billion and $34 billion. We have received over forty per cent of all Japanese direct inward investment into the EC.

BOX I BENEFITS OF FOREIGN INVESTMENT

A good example of the benefits of foreign investment has been in the UK car industry. The Nissan plant in the north of England is already the most efficient car plant in Europe. By 1997 it is expected that Japanese manufacturers will account for nearly one third of total UK production. While most of the components are sourced locally, two thirds of the production is destined for export - some cars are already being exported back to Japan.

8. The UK has welcomed these high levels of foreign investment. The direct employment benefits are obvious. Its benefit in strengthening and expanding the private sector is also important, with important spillover benefits for the rest of the economy. Inward investors are often representative of best practice technology and management in their country of origin and competitiveness of UK firms is enhanced as a result of facing direct competition with them. Furthermore UK suppliers and customers benefit from exposure to the technology, management practices and quality standards. The new skills injected by foreign companies into the UK labour force diffuse throughout the economy. The result for its whole economy is increased productivity, higher growth and improved exports.

BOX II UK POLICY TOWARDS FOREIGN INVESTMENT

The UK operates a liberal inward direct investment policy, regardless of the form that investment takes (eg greenfield, takeover, joint ventures). Mergers policy has been based almost exclusively on competition considerations. Similarly, apart from a few (non-binding) local content agreements, notably in the vehicles sector, inward investors have not been subject to performance requirements. The UK has actively encouraged greenfield foreign investment through a mix of

marketing efforts and Regional Selective Assistance.

The 1980s also saw a number of measures in the UK that have increased the attractiveness of Britain as a place to do business.

* relaxation of exchange controls;

* financial deregulation;

* reduction in both corporate and individual tax rates;

* industrial relations reform;

* participation in the European Single Market;

* firm commitment to low inflation.

However perhaps the key policy initiative during the 1980s was the Government's privatization programme. Privatization sends a number of important signals to potential investors:

* it demonstrates a commitment to a market led economy, based on competition and free trade.

* most important of all it demonstrates a commitment to the private sector as the engine of the economy.

Portion direct investment in developing countries

9. A number of developing countries are already reaping the benefits of FDI. Countries are seeing the benefits of reforms which have liberalized their economies and encourage the private sector. Especially in the wake of the debt crisis, countries are aware of the advantage of remittances on foreign investment being dependent on performance, unlike loans which have to be serviced regardless of circumstances. FDI is increasingly seen as a valuable means of financing current account deficits and - in countries where there are no buoyant domestic capital markets - as a means of financing the private sector.

BOX III UK AS AN OVERSEAS INVESTOR

Investment by UK companies, financial institutions and individuals has played an important role in other economies. Between 1981 and 1990, the UK invested $184 billion

overseas, second only to Japan. However these figures refer only to direct investment. The City of London has played a major role in the rapid growth of portfolio investment flows.

Ever since 1980 when exchange controls were abolished, the UK has placed no restrictions on outward capital flows. The UK has had a generally permissive and supportive policy towards overseas investment, recognizing the commercial benefits this gives to domestic firms.

10. For investors looking overseas, confidence is the key. Financial incentives and the like may have a role to play but it is much more important that the fundamentals are right. On the basis of UK experience as an overseas investor, the key elements in developing this confidence are likely to be:

* a stable economic and political environment - low inflation is vital;
* a clear commitment to the private sector;
* a transparent, fair, and uniform legal framework, which does not discriminate against foreign investors;
* an efficient and adequate infrastructure;
* an appropriately educated and skilled labour force;
* the prospect of growing and profitable markets, internal or external;
* the ability to repatriate profits and dividends in hard currency;
* a willingness on the part of the government to join appropriate international bodies, such as MIGA.

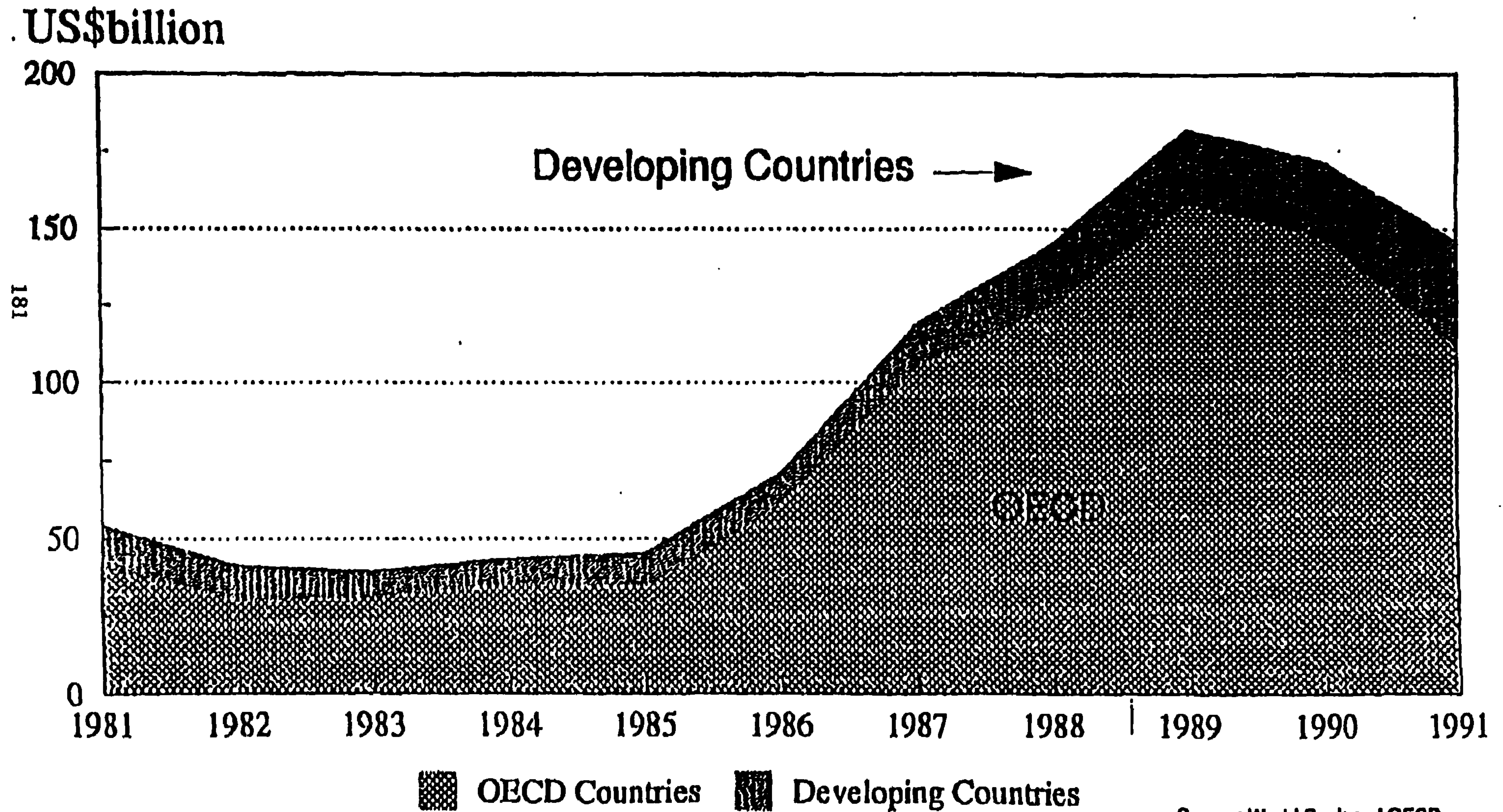
11. Attracting foreign investment is not easy. Rebuilding foreign investor confidence takes time, particularly in countries which have pursued distortionary policies which are inimicable to private investment. Many countries are still seen as high risk, and investors will demand appropriately high returns in compensation.

12. Furthermore foreign investment in many countries is only likely to be attracted to relatively large projects and enterprises. Development of small and medium scale industry will have to be largely reliant, at least in the foreseeable future, on domestically raised capital or on external capital derived by one means or another from public sector institutions such as the multilateral and bilateral development banks. The World Bank Group has a vital leading role to play both in providing and catalyzing external financial flows to such borrowers and in promoting the development of domestic capital markets.

HM Treasury
14 April 1993

Graph 1: Receipts of Foreign Direct Investment

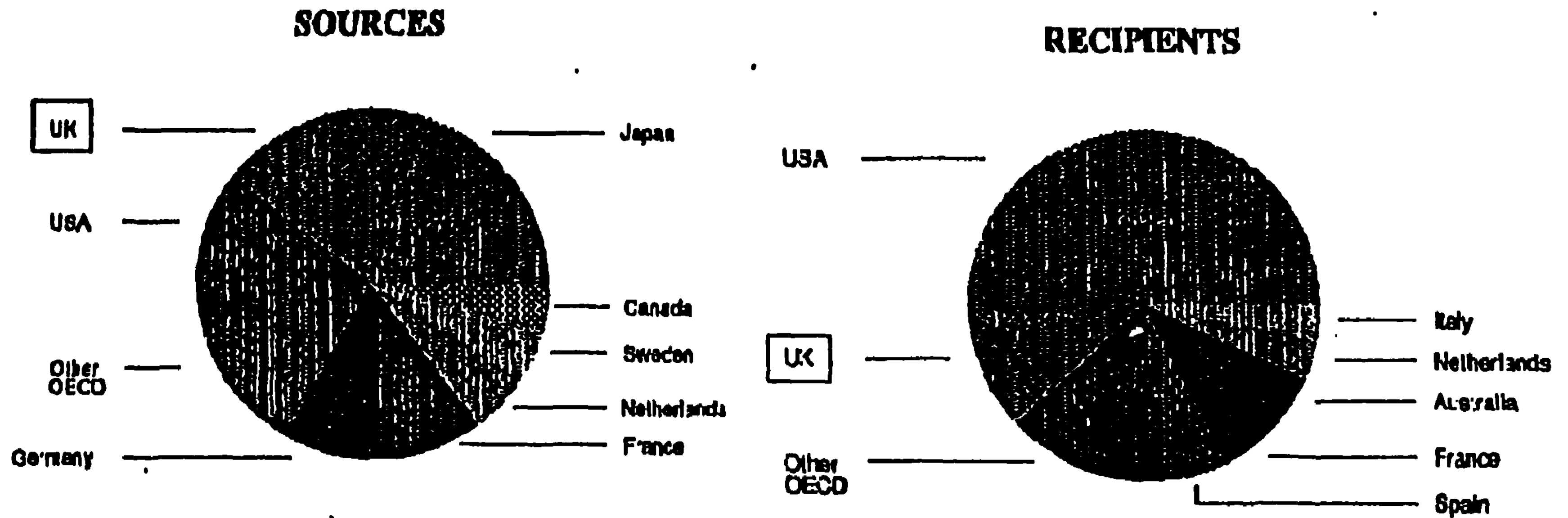
OECD and Developing Countries



GRAPH 2

OECD SOURCES/RECIPIENTS OF FOREIGN DIRECT INVESTMENT

(1981-1990)



Source: OECD

ENHANCING THE FLOW OF PRIVATE FINANCING FOR INFRASTRUCTURE PROJECTS IN EMERGING MARKET COUNTRIES

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Introduction

This paper sets out some suggestions for strengthening the role of the official credit institutions - most notably the World Bank - in improving the flow of private capital for financing of infrastructure projects in the more creditworthy developing countries. Obviously, this addresses only a small segment of the overall financing requirements of developing countries, i.e., that segment where there is at least some prospect of accessing private capital markets and thus where the official institutions are in a position to play a catalytic role. For the poorest countries concessional development assistance is the only form of financing that makes sense. And for countries where credit standing is impaired by excessive debt, a poor track record of economic management or a general inability to meet the performance criteria that private investors demand, the multilateral and bilateral official institutions remain indispensable both as credit intermediaries and an arbiters of lending conditionality. The comments here also focus on improving access to securities markets, for two reasons: first, the International Financial Institutions' (IFIs) ow ntermediation role focused here. Second, commercial banks are institutionally geared to dealing with credit analysis and risk management in ways that major institutional investors are not. If ways can be found to create credit structures that are acceptable to non-bank investors, then access to banking markets should also be relatively assured (or at least materially enhanced).

The principal recommendations call for the institutions, particularly the Banks to be at the same time both innovative and more restrained in directly providing financing projects. The innovative part is to (a) find ways of building domestic institutions and project entities that are self-sustaining financially, with good economics and operating in a legal and regulatory framework that makes them creditworthy within their own domestic markets; and (b) develop an acceptable way of providing limited coverage for the risk of non availability of foreign exchange to meet debt service obligations to foreign investors. The more indirect financing part is for the IFIs to be willing to underwrite risk in projects on an arms-length basis, leaving it to the private sector to design and structure financing transactions that meet predetermined and well-defined underwriting criteria. These are clearly not revolutionary suggestions, but will, at the margin, increase the flow of private capital into infrastructure projects in relatively creditworthy countries. The demonstration effect of increased access to capital by these countries should also provide important input to the Bank's overall policy dialogue with other borrowers somewhat further down the creditworthiness ladder.

Some Background

Structural changes in domestic capital markets and improved international creditworthiness of some developing countries have generated strong interest in more market-oriented approaches to the financing of infrastructure projects. The BOT technique, for example, is being explored throughout the developing world as governments seek new ways of mobilising investment funds. The forces driving this change in infrastructure financing policy are many and varied, but two in particular stand out. The first is a philosophical shift away from an all-pervasive state role in the provision of infrastructure services. The second is a recognition that government budgets throughout the world -- including in the industrial countries -- are badly overstretched, hence the desire to find "off budget" ways of financing major investment projects. In some cases, the conclusion is reached that infrastructure should be privatised. This is almost universally true of telecommunications and airlines, and increasingly so for power generation, other major transport services (trunk highways and bridges where tolls can be levied), and some water supply and waste treatment facilities.

In this way additional (non-budget) revenues can be generated at source through user fees and financial market discipline can be substituted for direct government control over the operations of infrastructure enterprises and project entities.

Put simply, the infrastructure financing problem is twofold: first, how to create a domestically viable and creditworthy project in terms of being able to generate adequate revenues in local currency on a sustained basis; second, how to deal with the cross-border risks that arise with investment from foreign sources. In developed markets, structuring the financing package for an infrastructure projects focuses exclusively on the first aspect, either because the financing is being raised domestically or because the existence of a stable, convertible currency means that foreign investors are willing to accept cross-border risks. For example, in the United States, a toll road or airport project is commonly undertaken by a specific authority that has the legal power to issue bonds, levy fees, etc. Such an authority may be a publicly sponsored corporation, a private company or a public-private hybrid. It operates within a well-defined legal and regulatory framework and has a financial structure that lends itself to analysis with respect to credit quality. Credit rating agencies play a central and indispensable role in evaluating the operations and financial performance of the authority, in effect, on behalf of investors who either do have the capacity to evalue such risks on their own or who prefer to rely on the specialisations and objectives of the rating agencies.

Differences in economic and financial performance as well as regulatory environment play a major role in determining differences in credit ratings. In competing for funds within a well developed capital market, different authorities and jurisdictions thus compete not only on the basis of the economic potential of the project but on the relative quality of the institutional framework within which the project is set. The absence of such a framework is one of the principal reasons why developing countries find it so difficult to attract foreign capital for infrastructure projects. More attention clearly needs to be given to creating the conditions under which domestic capital can be mobilised for such projects, and this means giving more attention to the development of domestic capital markets. Inflation and economic instability contribute greatly to the ineffectiveness of domestic capital markets to become adequate sources of financing. Unfortunately, too often governments try to attract foreign capital into institutional circumstances that are equally unattractive to domestic investors. Providing solid, practical advice on legal and regulatory frameworks conducive to private financing in infrastructure projects should thus be high on the Bank's list of technical assistance, supported by appropriate conditionality in sector and investment lending.

The private sector financing sources regularly look to the Bank for just this type of support. Infrastructure projects are inherently vulnerable to government policy and regulation. They generally produce a single output (e.g., electric power) which is either sold to a single customer (e.g., a power utility) that is itself state-owned or sold at prices regulated by government (e.g., toll road tariffs). The investment is usually large and long-lived, hence the returns are exposed to changes in government policy over a long time period. Generally, the output cannot be exported, nor can the physical facilities be re configured to produce something else. In short, most infrastructure investment is entirely at the mercy of the legal and regulatory regime -- plus the economic environment -- created by the host government.

Investors in such projects thus have to make decisions on the basis of the government's track record in economic management and in providing a stable and predictable institutional framework for the investment. Where the track record is weak or non-existent, investors will seek extensive additional protection from third parties, notable export credit agencies, political risk insurers and the multilateral institutions. The attitudes of rating agencies -- to the extent that they have a role to play -- will reinforce these concerns.

Enhancing Project Creditworthiness

Two different roles can be envisage for the World Bank in improving the bankability of projects. The first is to work on the institutional framework. Through its overall lending relationship with the country and its policy dialogue on sectoral and regulatory issues, the Bank is in a unique position to assist countries in

establishing a creditworthy environment for infrastructure projects. The second is to guarantee or otherwise enhance the obligations of the government or its agencies towards the project. As noted above, most such projects rise or fall on the strength of the government's credibility as a purchaser or regulator of infrastructure services. Compared with private investors and lenders, the Bank is in a far better position to evaluate the nature of these "political" risks and, more importantly, to manage them. The Bank's central role vis a vis the government means that it can obtain remedies and rectify problems far more effectively than a investors in a singe infrastructure project. Obviously, the Bank can play this role only where it is convinced that the government is committed to policies that will eventually generate the confidence of private investors. World Bank guarantees in infrastructure projects should thus be viewed as transitional measures designed to accelerate access to private capital on the basis of reforms that the Bank is prepared to support but for which a track record has not yet emerged.

This may require the multilateral institutions to adopt a somewhat different approach to financing of such projects. They should probably not be the lead lender for the project with a responsibility for structuring the financing package and organising cofinancing from other sources. Rather it should leave these tasks to the private sector and try to restrict their role to improving the policy framework, filling financing gaps and extending guarantees as necessary on the obligations of the government or its agencies in order to create a financing package that is viable. This implies a willingness to be an underwriter of risk with less direct control over the design and implementation of a project than the World Bank usually has. Financial structuring and arranging of the financing package would need to be left to private sector organisations. Indeed, if the institutions continue to play the lead lender/arranger role, they will inevitably monopolise this function (since the costs of the service are never explicit, being imbedded in the lending rate rather than paid as a eparate fee as is the case in purely private sector financings). Also they are likely to be so tied to the project that they are not in a position to objectively evaluate risk and negotiate effectively to minimise its credit support to the project.

The multilateral institution will also need to develop new skills in credit evaluation and in discriminating among project risks. Much like rating agencies, they will need to evaluate the precise nature of the risk in a project (rather than simply looking at all-encompassing country risk) and decide to what extent the specific project requires its support and in what form. Indeed, one suggestion would be for the World Bank to develop a specialised unit that works closely with credit rating agencies -- a number of whom are becoming international -- to establish an independent rating for the debt obligations of the project entity and provide sophisticated input to the design of Bank credit enhancement policy and implementation.

Not all projects will require the same degree of credit support. In some cases, the legal and regulatory framework is sufficiently developed and the government's credibility sufficiently high that the domestic (local currency) risks are acceptable to private investors. In such cases, the Bank could confine its intervention to reinforcing the institutional framework and help with the remaining cross-border risks. In others, the local risks will be too high (e.g., performance risk under a power purchase agreement in which the state owned utility has a history of arrears and excessive consumer subsidies) and the Bank will need to lend its support assuming the Bank believes that the government will perform and/or can see a way to enforce compliance should problems arise. In still others, the performance risks will be so severe that the private sector will demand full World Bank guarantees, in which case the Bank may find it more acceptable to lend directly to the project itself.

In all projects, construction risk is a particularly difficult problem and the institutions will frequently be asked to play a role in guaranteeing the completion of the project. While this may raise a number of special policy issues, from a risk standpoint it is essentially the same as undertaking the project in the first instance as a traditional IFI loan but progressively transferring risk to private investors as the project is put into service.

Specific financing techniques to enhance the creditworthiness of projects also need to be encouraged. For example, the World Bank has indirectly provided "mezzanine" finance by helping fund government sponsored term

financing facilities such as the PSEDF in Pakistan. There are a set of well-developed credit enhancement techniques in the United States such as State Revolving Funds (SRFs) that could be adapted for similar purposes in emerging market countries. Project reserves, pooling of the risks in a number of projects into a special financing vehicle, underpinning project economics with partial grant financing are all ways of strengthening creditworthiness. The key, however, is to begin to apply sophisticated techniques of risk assessment at the project level and to adjust both the legal and regulatory framework and the financial structure of the project to make it "bankable".

One needs to be realistic, however, about the degree to which the Bank can simply rely on technical advice and institutional development. Credit risk -- even in this limited domestic sense -- will remain high in many projects in many countries. In the absence of well developed institutions and especially a well-developed domestic capital market, the Bank's ability to extend guarantees and long-term financing will remain remain essential.

Cross Border Risks

The risks discussed above affect domestic as well as foreign investors and need to be dealt with even if one is simply pursuing a more modest goal of making infrastructure projects more genuinely free-standing and financially independent. At least two additional complications arise when part of the financing for an infrastructure project comes directly from foreign investors: first, exchange rate changes can have a profound effect on project economics; second, debt service and dividend payments are vulnerable to overall macroeconomic conditions and the availability of foreign exchange to the project entity.

The first of these risks is really a variant of the domestic credit risk discussed above and can be dealt with through similar approaches. However, it is worth noting that it is not simply a matter of indexing tariffs in foreign exchange terms (e.g. x cents per kilowatt hour). All regulated public service tariffs have a political dimension to them and at some point the effects of currency depreciation on project economics and hence required tariffs can become so large as to call into question the credibility of a well-intended tariff policy that is based on maintaining revenues adequate to service foreign exchange denominated debt and/ or equity returns that are indexed to a foreign currency.

The second of these cross border risks is the one most frequently cited by foreign investors as the key obstacle to attracting more private financing for infrastructure projects in developing countries. For any foreign investor it looms particularly large in infrastructure projects for reasons clearly mentioned. Such projects are typically large investments producing a single output for only one or a few customers, frequently a state entity itself, etc. In short, foreign investors are locked in for the life of the project and thus are extremely sensitive to potential disruptions in foreign exchange availability, even in relatively well developed countries with a reasonable track record of stable economic management and a favourable institutional structure.

Again, there are wide variations in countries, hence in the degree of comfort that foreign investors are prepared to accept. The Bank need not extend full guarantees in all cases, even though greater coverage means a better credit rating and a more wide-spread investor base. For the more creditworthy countries, a willingness to ensure that some portion of the foreign exchange requirements would be met should be sufficient, as already recognised in the Bank's ECO program. How much coverage is enough? This is difficult to say in the abstract, but a step forward would be for the Bank to establish some fairly simple guidelines, more elaborated than is presently the case in the ECO program but not complicated or excessively rigid, and then let the market find the best way of making use of whatever credit enhancement resources the Bank is prepared to provide. A starting point for analysis would to be provide, say, 3 to 5 years of coverage for debt service in the event that the project entity has the necessary local currency but cannot obtain foreign exchange to meet the obligations to foreign investors. There is no magic to this time period; it is simply a rough order of magnitude as to how long it will take to correct a balance of payments problem or at least resolve disruptions in payments to bond market investors (in contrast to the protracted time scale that was

required to deal with commercial bank debt in the 1980s).

Interestingly, this concept of a limited period of time to restore foreign exchange availability is embedded in the Bank's Articles of Agreement as a mechanism for avoiding default under Bank-guaranteed bond issues. While the provision is framed in terms of purchase and repurchase of currency (paralleling language in the Fund's Articles) and has never been used, the principle is nonetheless part of the Bank's early history and reflects the conviction of the Articles drafters that the primary role of the Bank would be to guarantee bonds issued by developing countries to finance specific projects. As it turned out, the Bank quickly developed its own capacity to borrow and found it simpler to lend directly rather than guarantee. Unfortunately, given the way the Articles are written, there is no scope for leveraging the Bank's capital base through guarantees. Apart from a modest concession for non-callable guarantees, both count equally against the Bank's lending limit. As a result, there is an inherent bias towards lending guarantees in the Bank's capital structure. The same is true for some of the other IFIs.

Over the years, numerous attempts have been made to work around this bias, but in the end the choice comes down to a balance between the benefits of institution building and more effective support for borrowers' efforts to mobilise private capital and a set of concerns about entanglement with private creditors and potentially adverse reactions by the Bank's own investors to a rescheduling of a Bank-guaranteed bond. In the absence of clear economic gains from a more leveraged use of Bank capital through guarantees, it has always been difficult to overcome the concerns sufficiently to commit the necessary staff resources and management support to the type of technical assistance and institutional development described above. Thus, the goal of fostering more "off balance sheet" financing approaches and a more "genuine lender of last resort" approach has been consistently forestalled.

The bias towards lending could be corrected by an amendment of the Bank's Articles. The arguments against amendment are well known and it may remain an impractical option. An alternative would be for the shareholder governments to establish a special purpose subsidiary of the Bank that would provide the sort of limited foreign exchange availability insurance described above. This could be done by a majority vote by the Bank's Board. Such a subsidiary could be capitalised as necessary and given sufficient reserves and liquidity to carry out the limited function required. By focusing on projects that meet high standards in terms of domestic creditworthiness, the subsidiary would assemble a portfolio of risk that is both restricted and diversified. It would have an incentive to develop ways of hedging risk across the portfolio, again something that private markets feel the Bank has a unique capacity to do. Such an insurance vehicle is an obvious gap in the multilateral system and could in co-operation with MIGA and other entities substantially enhance the flow of private capital for infrastructure projects. It could also be established as a joint venture of one or more of the IFIs.

Conclusion

These two suggestions -- a specific program of institution building and a limited risk insurance subsidiary -- would materially enhance the international institutions' catalytic role in developing domestic capital markets and in mobilising private finance for infrastructure projects. Neither is revolutionary, and together they focus on only one aspect of financial flows to developing countries. The number of emerging market countries for which this approach would work is limited, but growing. And hopefully the demonstration effect of success in attracting finance on market oriented terms will have an important catalytic effect on the objectives and commitment to policy reform of a much broader set of countries.

TRANSFER OF PRIVATE RESOURCES TO THE DEVELOPING COUNTRIES

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This brief note contains some observations on practical steps and approaches that governments of developing countries might wish to consider in connection with their efforts to promote the inflow of foreign capital. It is neither analytical nor comprehensive in its treatment. it begins with a brief analysis of the experience with capital flows in the 1980's and the lessons to be learned from that experience. That is followed by some suggestions for capital importing and exporting countries and for multilateral institutions, aimed at promoting the transfer of private resources to the developing countries.

Capital Flows in the 1980's.

The trends in private capital flows in the 1980's provide a useful backdrop for considering the prospects and the potential for promoting foreign capital flows to the developing countries. A retrospective analysis provides useful lessons for developing countries that wish to attract foreign capital, for multilateral institutions that have an important catalytic role to play in the process, and for the governments of the industrialized countries that also stand to gain from the free flow of capital.

The more important component of private capital flows is foreign direct investment (FDI) During the 1980's, total FDI increased nearly four-fold but some 90% of the increase went to the developed countries, mostly to the US and Western Europe. The amount of investment going to the developing countries roughly doubled to around $20 billion, but their share in total FDI dropped from about 18-19% in the early 1980's to 11-12% towards the end of the decade. A small number of countries were the major beneficiaries of these flows. Nearly one-half of the total went to five countries (Brazil, Singapore, Mexico, China, and Hong Kong) and nearly three-quarters to ten countries.

The growth of foreign portfolio investment (FPI) in the developing countries during the 1980's has been even more rapid than that of FDI. There are now 200 closed-end emerging market funds with assets of $20-25 billion in capital markets whose capitalization has risen from less than $5 billion to well over $20 billion in 1992. Moreover, there is a broader range of countries receiving FPI, with the volume of FPI more closely linked to the performance of individual security markets.

The Lessons of Experience.

The experience of the 1980's suggests the following broad conclusions:

(i) Countries must be realistic in their expectations regarding the potential flow of FDI and the time it takes to achieve a substantial increase in its level. Creating a more hospitable policy and regulatory environment is a necessary but not sufficient condition for attracting foreign capital. Foreign capital inflows are also influenced by other country circumstances and attributes such as market size, effective infrastructure, a skilled labor force, and efficient and stable governance.

The experience of the 1980's shows that countries at a higher level of industrialization and development are more successful in attracting foreign investment; and those that have relatively large domestic markets or provide good potential for manufacturing exports, are particularly favored. In the smaller and poorer countries, by comparison, it is relatively more difficult to attract large amounts of direct foreign investment even if they create a favorable policy environment and offer incentives that are competitive with those of other countries. However, a few small countries such as Hong Kong, Singapore, and Mauritius are notable exceptions. They have benefited from being the leaders in establishing "open" economies with "liberal" economic regimes that provided a "level playing field" for domestic and foreign private investment.

(ii) The contribution of FDI to the economic advancement of developing countries is likely to be more important in "qualitative" rather than "quantitative" terms. In other words, the principal benefits of FDI are more likely to be found in the areas of technology transfer, access to markets, skills upgrading and efficiency enhancement through increased competition rather than in the volume of resources it adds to the financing of domestic investment. However, even very modest amounts of FDI flows could be valuable in upgrading a country's productive system and stimulating the growth process.

(iii) There is no single approach towards promoting foreign investment that is suitable for all countries. While there are some features that are common to most successful investment promotion programs, there are also important differences in the economic situation of countries which call for some variation in approach.

(iv) Foreign investors have developed a much more "global perspective" in recent years and therefore individual countries have a much better opportunity than in the past to attract foreign capital provided they effectively market their

strengths. The information revolution, the globalization of capital markets and the ending of the cold war have all contributed to a much more global approach on the part of transnational corporations to issues of "sourcing" and "location" of production.

(v) While security markets were not a major source of industrial and business financing during the early stage of development in the industrialized countries, there is reason to believe that in the current world environment of global capital markets and instant communications technology, they can be a much more potent force for attracting foreign capital. Moreover, unlike FDI which tends to build up slowly, FPI can increase very quickly, as a result, for example, of repatriation of flight capital following major improvements in the policy environment and the re-establishment of confidence, or in association with the introduction of a major privatization program.

(vi) Governments in developing countries have a very important role to play in creating a domestic environment that is conducive to the flow of foreign investment. This role is very different from that performed by many governments in the past when they intervened excessively and took over active management of productive assets. The role of government should instead be similar to that envisioned by Adam Smith in the Wealth of Nations, namely to ensure that there is an adequate regulatory framework for the efficient functioning of the economy, and that there is adequate investment in basic infrastructure and human resource development, and that the functioning and management of most productive assets is left to the private sector.

An Agenda for the Future.

Herewith a checklist of selected actions that should be high on the agenda of the three parties concerned: the capital importing countries, capital exporting countries, and the multilateral institutions:

The Capital Importing Countries:

1. Formulate an Investment Promotion Strategy which highlights the country's comparative advantages, establishes the government's objectives and priorities for foreign investment, and sets out the policies and actions that will create an appropriate enabling environment. A government that wishes to attract foreign investment in the export sector while maintaining an over-valued exchange rate is unlikely to succeed. Equally, a government that has reformed and liberalized its economic policies but continues to maintain a system of burdensome bureaucratic clearances for individual investments, is likely to

be thwarted in its attempts to attract foreign investment.

2. Set out the "rules of the game" for foreign investors that are consistent with the Investment Promotion Strategy. Foreign investors place a high premium on knowing with some certainty what they can or cannot do. Similarly, the risk and reward perceptions of investors are affected by the degree of confidence they have in the continuation of the prevailing investment regime. The best system is one which does not distinguish between domestic and foreign investment. In any case, the rules governing foreign investment should be precise and totally transparent, and should be left unchanged for as long as possible.

3. Ensure that domestic private investors feel well-treated and are flourishing. If a country has a buoyant domestic private sector, it is bound to attract foreign capital.

4. Allow foreign investors the freedom and the ability to manage their investments effectively. The investor must be in a position to control the decision-making process, and have a measure of independence in managing the investment without fear of external intervention. Management independence typically comes from majority ownership, although control can be acquired even as a minority shareholder. Most developing countries that have succeeded in attracting large amounts of foreign investment, have been prepared to allow majority foreign ownership in domestic enterprises.

5. Liberalize capital exit and entry requirements: the removal of restrictions on foreign exchange transfers -- both on the current and capital account -- is usually the most visible sign to foreign investors of a change in the attitude and approach of a government. A foreign investor must be made to feel that he can make a profit and transfer it without hindrances. Liberal "exit" conditions are therefore an acid test of the government's attitude towards foreign investment.

6. Establish a fiscal regime that is perceived to be equitable to investors. Many countries continue to penalize business with penalty rates of taxation. Marginal rates of corporate taxation should be adjusted broadly to international levels.

7. Give high priority to the development of an efficient and modern financial system, and open it up to foreign participation. The absence of strong and efficient financial institutions that can provide and develop essential financial services to support the growth of business and industry is a major deficiency in many countries. There is an urgent need to open up banking, insurance and pension fund management to privatization: foreign participation in the financial system can

be a strong positive force for the modernization of the system by injecting new technology and competition. This has acquired heightened importance with the globalization of the financial system.

8. Develop a well-functioning security market that provides an effective conduit for FPI. Aside from establishing adequate statutory regulation of security markets and encouraging maximum "self-regulation", governments need to ensure that a growing part of institutional savings are channelled into the security market to give it liquidity and depth. Mandatory contributory pension schemes -- both in the public and the private sector -- are an excellent way of channelling institutional funds for long-term investment into the market. In addition, governments need to require that the tax system does not penalize security market development -- e.g. it distinguishes between short-term and long-term capital gains, that it avoids double taxation of investments and securities (i.e. through the removal of the withholding tax on dividends), and that foreign investors are protected through double taxation treaties.

9. Undertake a sustained marketing effort aimed at providing potential investors with information on business conditions and opportunities, regulations and procedures governing investment, institutional service and support capabilities, etc. A satisfied and functioning foreign investor is the most effective advertisement for a country's investment regime.

10. Envision, as noted earlier, an activist role for the government in providing good governance, and a regulatory framework that ensures free competition which is the hallmark of a well-functioning market system.

Governments of Capital Exporting Countries:

1. Provide incentives to institutionally managed portfolio funds to invest in the developing countries.

The total stock of institutionally managed portfolio funds in the industrialized countries probably amounts to about $14-16 trillion, while the stock of developing country debt and equity held by investors from the industrialized countries is estimated at only about $60-70 billion. Therefore, even if only 1% of the global institutionally managed portfolio could be invested in the developing countries, the transfer of capital to them could be more than doubled. Even modest tax incentives to the Funds for making such investments would easily achieve this target and it would be a much more effective and less expensive method of providing capital to the developing countries than, for example, giving them aid.

Aside from the above, there is need, in any event, for liberalizing the application of prudential regulations by regulatory authorities on lending and investment by financial institutions to developing countries. Current regulations, and especially the manner in which they are applied in many capital exporting countries, inhibit them from investing in developing countries.

2. Expand fiscal treaties and agreements to avoid double taxation

While tax treaties and fiscal arrangements are now in place among many countries, there are some countries that are not covered and the scope of some of the agreements need to be expanded and made more comprehensive.

3. Liberalize immigration rules to permit exchange of human capital

Current immigration rules in industrialized countries make it difficult for enterprises to recruit foreign nationals, including those from joint venture/partner companies, for training and career progression. Reciprocal liberalized immigration arrangements between capital importing and exporting countries would remove a major irritant to the effective flow of capital.

The Multilateral Institutions:

The multilateral institutions -- the World Bank Group and the IMF,, the Regional Development Banks and the UN Specialized Organizations -- are currently engaged in supporting a broad range of policies that help promote the flow of foreign capital. The areas outlined below are those where a more aggressive and expanded role by these institutions would now be timely:

1. Provide more active support for private sector financing of infrastructure.

Infrastructure deficiencies and environmental degradation now loom as the major obstacle to sustained development in most countries of Asia, Latin America, and Eastern Europe, and public sector resources are totally inadequate to meet the requirements. The multilateral development banks can increasingly shift their attention to issues of human resource development only if the private sector, including foreign private investment, can be mobilized in a major way for the financing of infrastructure and the environment. This is feasible provided the multilateral development banks show some leadership in this area and play a catalytic "umbrella" role. While a few B.O.T.

(build-operate-transfer) or B.O.O. (build-own-operate) type projects are under consideration, the development banks have been slow to develop the instruments and the approaches that are necessary to provide a strong stimulus to private sector involvement. The direct involvement of multilateral development banks in establishing "Infrastructure" and "Environment" Investment Funds that mobilize private institutional funds, should be actively explored.

2. <u>Provide more effective support for privatization programs:</u>

Some of the observations concerning infrastructure financing apply also to support for Privatization programs. So far the World Bank and the regional banks (with the exception of IFC and, to some extent, EBRD) have performed only a limited role in this area, largely confined to policy advice, training, etc. However, financial markets and institutions in many countries do not have the depth and liquidity to provide the needed support for major privatization programs, and IFC, and similar other affiliates of the multilateral banks, do not have the resources to intervene effectively. Therefore, more direct participation and involvement of the multilateral development banks in supporting the privatization effort is required.

This has particular relevance for two special cases -- Africa and Russia -- which, for a variety of reasons, will confront special problems in privatization. In the case of the African countries, consideration should be given to establishing, under the auspices of a multilateral development bank, a "Debt to Equity Conversion Fund" that converts some of the outstanding debt of these countries into the equity of the companies to be privatized. In the case of the Russian Federation, one of the multilateral development banks could help set up a "Privatization Fund" to provide "mezzanine" financing for privatization. This will enable the enterprize, which is to be privatized, to continue to function, and it should allow a beginning to be made on its "restructuring", pending the actual sale of the assets or the locating of a joint venture partner.

3. <u>Expand the scope of MIGA's activities</u>:

MIGA remains a highly relevant but limited organization in terms of the coverage it provides. Its contribution to promoting foreign investment could be greatly increased if the size and type of risks it covers could be broadened. The feasibility of doing so should be explored in the light of its recent experience.

EXPORT FINANCE AS A SOURCE OF FUNDING FOR DEVELOPING COUNTRIES

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Introduction

I should stress at the outset that this paper is written in my personal capacity. It does, however, reflect my experiences in the private and public sectors in the U.K. and overseas, dealing with trade and export finance over the last 30 years.

Background

It is very difficult to generalise about all developing countries. However, I think it is possible to make a number of comments of pretty general applicability to a large number of them.

Commercial banks are very reluctant to provide medium and long term finance. There are various reasons for this but none are likely to be subject so significant relaxation or improvement in the next two or three years. Many banks are even reluctant to provide short term trade finance, even though such finance (unlike medium and long term lending) has only rarely become caught up in debt reschedulings under the London Club.

Most Export Credit Agencies (ECAs) have had difficulties over the least few years, paying claims (particularly in the medium and long term credit fields) well in excess of their premium income. Governments who have had to pick up the tab are, understandably, more cautious than they may have been in the past.

All the comments in this paper relating to the ECAs cover both those who give guarantees to banks and exporters and those who lend themselves.

Sovereign guarantees are often perceived by both commercial banks and ECAs to offer less than perfect security for new credits/lending. As a result, new projects in many countries have become either very difficult to finance at all or there has been greater interest in project and non-recourse financing, where the main security is the viability of the project itself. Foreign exchange earning projects offer the possibility of establishing security packages for the required/associated credits by the establishment of offshore escrow accounts to hold the foreign currency earnings of the projects. Such arrangements are of greater (and growing) importance.

I should stress that I have taken as one of my basic assumptions that aid flows will, at best, remain at about present levels.

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[1]The views presented in this paper are solely those of the author and do not represent the views of any organization with which he is affiliated.

Against this background, it will continue to be very difficult to finance resource flows to the poorest and least developed countries other than on an aid basis. Indeed, it is possibly not helpful to some countries to provide them with loans on commercial terms (i.e. 5 or 8 years credit at or about market rates of interest), the timely repayment of which are likely to prove beyond their means.

Thus, the rest of this paper will concentrate primarily on "Second Tier" Developing Countries, i.e. countries who still find difficulty in raising commercial finance but where it is not impossible to see this position changing for the better in the not too distant future.

Fundamental Question

The basic question I shall try to address is what can be done to increase the flows of credit and investment. This will cover both what could be done differently by a range of institutions and also what new or additional things might be done. Of particular importance will be the role of the private sector in both lending to/investment in borrowing countries since it is simply not possible for the International Financial Institutions to provide all (or even most) of the finance or investment for projects which is required. Thus cofinancing is of quite central importance.

International Financial Institutions (IFIs)

The policy and practices of the IFIs often seem to discriminate in favour of the commercial banks and against the Export Credit Agencies. This is particularly true in the area of cofinancing. No doubt there are historically valid reasons for this but it is, in my view, indisputable that it has led, and continues to lead, to less credit being made available by the ECAs than would otherwise be the case.

I would argue that, as a basic position, the IFIs should be willing to make available to the ECAs whatever facilities or support etc. they make available to commercial banks -- it need not be better but it is very counter productive for it to be worse. Neither should the IFIs get sucked into providing -- ever wider and deeper and increasingly unconditional -- "guarantees" to try to attract commercial bank lending when they (the IFIs) would need to do less to bring forward ECA financing.

Similarly, it is not helpful for the IFIs to seek to share their preferred creditor status with commercial banks on projects and expect the ECAs happily to accept that commercial banks will then rank ahead of them in any creditors queue. The basic fact is the same in all these cases, namely that the natural cofinancing partners for the IFIs are the ECAs and that discriminating against them produces the worst of all worlds, e.g. it inhibits ECA finance but does little to bring forward commercial bank finance and risks, in addition, moral hazard for borrowers.

For a number of countries, the only way in which credit will be extended or foreign investment made in a project will be if a commercially acceptable security package can be established. A key part of this will, in the case of foreign exchange earning projects, often be the creation of an offshore Escrow Account to hold some proportion of those earnings of the project. If countries are not allowed to establish such arrangements due to Negative Pledges to the IFIs, then projects will simply not be done. ECAs are increasingly unwilling to contemplate taking a position subordinate to that of other financiers in a particular project.

A facility under which IFIs provided finance for the 15% downpayment on a project (which developing countries often have difficulty in raising either from their own resources or commercial banks) -- leaving the balance of 85% to be provided by the ECAs on a cofinancing basis -- could be a very useful "new" facility and could enable projects to take place which are otherwise blocked. ECAs are not permitted under the OECD Consensus (see below) to support 100% of a project value. Such a facility might well encourage reluctant ECAs to participate where IFI involvement gets closer to a greater sharing of risks.

The IFIs are an important source of information both on projects and on countries. This should be shared to the maximum extent with potential lenders, investors and insurers. This is particularly true where privatisations etc. are creating new private sector buyers who are not known to potential creditors and who have no track record or no accounts.

The IFIs have a central role in advice and guidance to debtor countries. Such advice should include matters of importance to creditors such as keeping the terms of signed Paris Club Agreements and not seeking any move of Cut Off Dates, as well as being realistic about the scale and nature of projects and associated borrowings.

The procurement procedures and international tender requests of the IFIs should be realistic -- especially where there IFI share of a cofinanced project is a minority one. For example, the ECAs are not in the business of supporting untied lending/credits and so will not normally be willing to support high levels of finance for procurement other than from their own countries. What is practical should be the key criteria. The same should be true of the complexity of procedures and documentation in that the IFIs should pay more regard to the needs and wishes and practices of their potential cofinancing partners. The IFIs should not expect to have the final or sole authority or say or power of decision in all situations, whatever their share of the lending.

Developing Countries

The overhang of existing debt is clearly an inhibiting factor to the generation of new credits and investments. Thus the extent to which debtor countries honour Paris Club Agreements will influence the decisions of

potential creditors and investors. This is particularly true of holding firmly to Cut Off Dates.

The provision of reliable information to creditors and investors is also important, especially when, as is now frequently the case, the economic and commercial scene is subject to rapid change.

New legislation bearing on commercial activity should be framed with the needs of foreign creditors and investors in mind. This is true not only of foreign exchange regulations and shareholding requirements as regards foreign investment but also of company law, legislation bearing on accountancy standards, bankruptcy regulations etc.

It is helpful to control the level of commissions: high commission payments not only deter potential lenders and investors but are clearly a waste of national resources.

"Window Shopping" on projects etc. is very counter productive. In other words, countries should be selective and realistic about the projects they pursue. A reputation for white elephant projects or unrealistic projects or too many projects takes a very long time to live down and deters potential lenders/investors/creditors from committing resources etc. even to considering projects.

Investment Promotion and Protection Agreements (IPPAs) can be helpful in developing confidence amongst both potential investors and ECAs who insure investment. However, it is of course important that they are not an end in themselves but form part of a general policy framework which is welcoming to foreign investment.

It might be possible for two or three developing countries (and even aid donors) to join together to provide some kind of "Regional" joint guarantee for projects and investments. This could help to bring forward additional credit and/or foreign investments.

Export Credit Agencies (ECAs)

As noted earlier, most ECAs are under pressure from their Guardian authorities. This means, inter alia, that they will underwrite rather more cautiously than may have been the case in the past.

However, it would be helpful if more ECAs were able and willing to carry out the analysis and appraisal etc. which is necessary to enable them to support projects which are structured on a project financing basis (and where payment guarantees are not required from the Governments of the buying countries). Resources committed to the development of these skills would be well worthwhile.

It would also be helpful if cooperation and coordination could be improved between ECAs so as better (from the point of view of buyers,

exporters and lenders) to structure and administer joint or parallel cover for projects where procurement is involved from more than one country.

The present terms of ECA cover for medium and long term cover (as regards size of downpayment, rate of interest and length and profile of credit) are governed by the OECD Consensus. One result of this is that interest rate subsidies have to a large extent been phased out of the system. However, it would enable a number of significant projects to take place if there could be some flexibility over the other Consensus terms -- and, in particular, the length and profile of the credit -- so as to match the repayment terms to the amortization needs of the project. For example, if the viability of a project needs a 12-year (rather than an 8-year) length of credit and repayments which are, say, larger in the last 8 years than in the first 4 years, this should be left to the underwriting judgements of the ECAs concerned and not "forbidden" by the OECD Consensus. Provided no interest rate subsidies are involved, this should not distort competition.

The Consensus should prevent market distortions and unfair/subsidised competition: it should not become an arbitrary restraint on finance being provided to match the amortisation needs of projects. The plain fact is that, as any insurer or investor should know, lengthening the credit need not mean worsening the risks. Indeed, repayment which matches the cash flows of the project probably represents a better risk.

ECAs could helpfully review the sources of finance in their countries to see whether their guarantees might not be structured (without taking new or increased risks) so as to bring forward finance from non-bank sources. Some ECAs have already experimented here by trying to tap the Capital Markets.

Investment Insurance

Investment Insurance is offered by most of the larger ECAs (and in the USA and Germany by specialist institutions) and by the IBRD and MIGA. It has been a useful role but it seems to me that it is important both not to exaggerate what it can achieve quickly or to raise false expectations. There are various reasons for this.

First and foremost, investment insurance excludes the whole range of commercial risks and, to this extent, it is unlike other ECA facilities. Second, investment decisions normally take a long time to come to fruition. Third, the foreign investment legislation position in many countries is unclear or undergoing significant change. Finally, the OECD foreign investment has been heavily concentrated in other OECD countries.

The lessons I would draw from this are:

a. Don't expect too much too quickly of Investment Insurance (all parties)

b. Do have "foreign investment friendly" laws and procedures (developing countries)

c. Do review current policies and terms of cover to see if more and different things (e.g. syndicated loans) could be done to support viable investment (ECAs)

d. Do (continue to) be flexible and to work <u>with</u> ECAs: it is essential that MIGA provides facilities which are complimentary and not competitive with those of the ECAs (MIGA).

<u>Exports from Developing Countries</u>

The establishment of ECAs in developing countries can be useful in stimulating exports. However, it is not helpful for such institutions to become vehicles for channeling subsidies into exports or for encouraging exports to countries (or buyers) which do not pay. A key point seems to me to be the help which ECAs can give (by taking the commercial risks and acquiring/monitoring status information on buyers and helping to recover debts or overdue payments) in increasing exports to OECD countries. For exports to other developing countries, there are important lessons to be learned from the experiences and problems that ECAs in OECD countries have had over the last 10 years and there are roles for all the parties mentioned above in enabling this "Technology Transfer" to take place.

<u>Summary and Conclusions</u>

This paper is intended to be a <u>practical</u> one. It tries to suggest certain actions which could be taken or certain practices/procedures/ policies which could be changed by various parties.

There are no simple or magic solutions but my strong view is that, if some of these points could be acted upon, the flows of credit and investment to developing countries could be increased with considerable potential benefits to all concerned.

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MEASURES FOR ENHANCING THE FLOW OF PRIVATE CAPITAL TO THE LESS DEVELOPED COUNTRIES

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1. *Introduction*

There appears to be a widespread consensus that many less developed countries (identified as second tier) could usefully absorb more capital, that is, the expected risk adjusted return to these investments exceed what should be the cost of capital (given interest rates in more developed countries). Increased flows of capital from the developed to the less developed countries could substantially benefit the less developed countries, particularly when that capital is accompanied by a flow of technology.

This brief paper focuses on what might be done to facilitate the flow of private capital. Several of the proposals resemble devices which have already been, or are being, tried. It may be possible to build on these past experiences and learn from the past failures as well as successes. In evaluating these past experiences, one has to be attentive both to particular design features as well as to the particular economic and political environment in which previous experiences have been conducted. The limited success of an experiment in venture capital firms in Africa does not mean that such firms might be more successful in other economic environments.

2. *Some Preliminary Remarks*

We begin by identifying the barriers, either in the host or source country. At the onset, it should be noted that even in the most developed countries, with the most well functioning of capital markets, there may be significant barriers to the flow of capital. There is evidence of persistent differences in rates of return across industries. Small and medium size firms often face difficulties in obtaining finance,

[1]The views presented in this paper are solely those of the author and do not represent the views of any organization with which he is affiliated.

particularly in periods of economic downturn. Equity markets are able to provide finance to but a small fraction of firms, and even these firms rely relatively little on equity markets as a source of capital. Even bond markets are a relatively small source of finance for firms outside a limited number of industries.

Equity has, however, distinct advantages relative to debt financing, because it shares risks more effectively. In the situations that many less developed countries find themselves, the high degree of risk makes the fixed obligations associated with debt particularly unattractive.

In this, and other respects, bank financing is superior to bond financing. It provides greater flexibility, and the potential for closer monitoring is also a distinct advantage.

In some countries, specialized firms--venture capital firms--have developed to meet the specialized needs of capital (and other managerial and financial needs) of new firms. But these firms require specialized knowledge. In only a few industries have venture capital firms gained the requisite knowledge to become a major source of funds for new enterprises.

It is important to bear in mind the distinctions among the forms of capital as well as the uses to which capital flows may be put. Real investment which carries with it new technology, and which is used for projects with large spillovers, may contribute in a positive way to the development effort. On the other hand, some countries have been concerned that large portfolio capital movements have lead to exchange rate appreciation with adverse macro-economic effects, destabilizing the economy. Equity capital provides better risk sharing opportunities, avoiding the by now familiar problems associated with excessive debt. Equity participation by both host and source country investors provides strong incentives both for the selection of good projects and monitoring.

On the side of both the host and source countries, perhaps the two most important barriers to the flow of capital relate to risk and information. In the presence of limited information and considerable risk, even in developed countries, there may be credit rationing. Thus, the fact that LDCs, and particular firms in LDCs, face credit rationing--limited access to funds--should come as no surprise. These

difficulties are compounded by the problems posed by sovereign debt.

3. *Risk of Real Interest Rate Variations*

With respect to debt instruments, LDCs (and firms within LDCs) have previously been asked to bear the brunt of variations in the real interest rate. In the period beginning in the late 1970s through the early 1980s, this cost them a great deal. This real interest risk should make them reluctant to encumber themselves with debt of short to medium maturity (or at least shorter maturity than the projects which it is intended to finance).

> *The more developed countries should be able to absorb this risk of a variation in the real interest rate. It should be possible to devise institutional mechanisms by which either the international financial institutions or source governments can do this.*

Such "real interest" insurance would alleviate another on going problem. Lenders often prefer to lend for maturities which are of shorter duration than the duration of projects. While short term loans have distinct advantages from the perspective of the lender--they afford him more control--they expose the borrower to uncertainty concerning the interest rate that will have to be paid when the loan is renewed. The real risk that the borrower faces is variations in the real interest rate. Though the real interest rate insurance would not eliminate the risk associated with a termination of credit, it could be used to reduce the risk of real interest rate fluctuations.

4. *Risk Diversification for Investors and Insurance Against Global Fluctuations in the Level of Economic Activity*

Investors in source countries face a number of risks, e.g. concerning macro-economic conditions in particular host countries, world-wide macro-economic conditions, policy risks within particular host countries (such as changes in tax laws and ability to repatriate funds). Some of these risks--those

pertaining to a particular country— can be reduced by diversification across countries.

Since particular source countries are likely to be more informed about particular host countries (often because of long term historical relations), it might be desirable for the International Financial Institutions to take the lead in helping form international private consortium (mutual funds), managed jointly by banks from several countries, and providing portfolio investment on a world-wide scale.

At the same time, the developed countries should recognize that fluctuations in the level of economic activities within their countries may be exported to the LDCs, and be a major source of undiversified risk for such a world-wide consortium. Indeed, to the extent that funds go to finance export oriented industries, and exports are sensitive to incomes in the more developed countries, the effects of economic volatility in the more developed countries may be amplified.

Thus, more concerted efforts on the part of the more developed countries to maintain economic stability would have strong beneficial effects in reducing risks in less developed countries, and thereby promoting the flow of funds to those countries.

To be sure, the developed countries may take upon themselves a responsibility for macro-stability. But of all the reasons for doing so, this is not likely to be one which weighs heavily in the minds of policy makers. Given past failures, we should expect future failures as well.

The developed countries can, however, provide a substitute, a kind of macro-stability insurance. When profits (returns) on the investments are low because of a macro-economic downturn in the more developed countries, the more developed countries or the International Financial Institutions could provide a compensatory payment, tied to the extent of the economic downturn.

While working out the institutional arrangements for this kind of insurance are likely to be somewhat more complicated than for the previous proposal, even imperfect insurance would be better than none,

and it should be easy to design simple systems to provide partial insurance.

5. Information barriers

There is a two sided information problem. Investors in source countries have limited information with which to judge either particular entrepreneurs or particular projects within host countries; and entrepreneurs in host countries have limited information concerning technologies and markets overseas.

One of the sources of the rapid growth in South China in recent years has been joint ventures, which have brought together capital, knowledge, and risk sharing, largely between various investing enterprises in China and those in Hong Kong. These joint ventures provide two further advantages: there are multiple monitors, increasing the likelihood that the enterprises are well managed; and the multiplicity of different interest groups make it perhaps less likely, from the perspective of both the foreign and domestic investors, that investment will be appropriated. While these arrangements have increased the flow of information (e.g. concerning alternative technologies), the flow is circumscribed; there is not (at least in many cases) a world wide search for the best, or at least most appropriate, technology.

At the same time, there is limited information on the part of enterprises in many host countries concerning the range of financial instruments, e.g. equity, bonds, preferred shares, and the advantages and disadvantages of each.

> *The IFIs are perhaps in a unique position to found a set of venture capital firms, focusing on selected sectors, but bringing together industry and financial experts from several of the more developed countries. Like the venture capital firms of Silicon value, such firms would be able to provide important financial and managerial assistance, marketing knowledge, and technological know-how. The could bring together projects in the less developed countries with potential investors in the more developed countries. They could*

help form joint ventures, taking shares in the enterprise themselves.

The international basis would make it more likely that the financial structure and the technology provided would be the most appropriate for the country. The fact that entrepreneurs/financial institutions within the less developed countries were willing to risk their own capital would enhance the likelihood of success of such projects and provide important assurances to investors in the more developed countries. The limited availability of equity by private entrepreneurs may prove to be an impediment for any but the smallest of projects. It may be desirable to undertake a serious effort to seek out entrepreneurs who will be willing to take significant stake.

An important feature of the venture capital firms is the form in which capital is provided; they have recognized that initial cash flows may be low, making debt finance inappropriate.

6. *Advantages of banks*

We noted earlier that bank finance provides several advantages over bond finance. In spite of these advantages, its role has been diminishing. This may be partly because of the difficulties that banks in many of the more developed countries have been experiencing recently, and partly because of the troubles that these institutions had with third world lending in earlier years. These difficulties suggest that these lenders may not have possessed (or exercised) one of the advantages often ascribed to banks, their superior capacity in monitoring. Banks in the more developed countries naturally focus most of their attention on investments in their own countries, or investments by firms from their own country abroad.

This suggests that there may be scope for the establishment of private banks specializing in international lending in less developed countries, perhaps organized as joint ventures of already established banks.

There is, as is often the case, a trade-off between the advantages of specialization and risk

diversification. A bank which is specialized in a single country may develop greater expertise in that country, but its profits are highly dependent on economic conditions in that country; an international bank investing both in developed and less developed countries has less specialized knowledge and greater opportunities for risk diversification. In the spectrum of possibilities, there appears to be a gap; there is not a set of financial institutions investing in many less developed countries, and therefore accumulating expertise in the particular problems of these countries, yet able to diversify across countries.[2] Establishing these banks as joint ventures of banks in several countries would enlarge the natural information base upon which the bank could draw.

7. *Risk of Partial Expropriation*

Investors face a risk that their capital be expropriated. Investors can obtain insurance against this risk. More subtle however is the problem of partial expropriation, through, for instance, increases in effective tax rates. Sovereign governments are not likely to surrender their right to raise taxes, but they may be able to sign binding agreements putting upper bounds on the tax rates that they will impose over various lengths of time. Failure to live up to these agreements would be met with the same kind of responses that are accorded other failures to live up to other agreements with international organizations, such as the World Bank.

Providing this kind of "extended coverage" under expropriation insurance might facilitate the flow of capital.

Though partial expropriations can take a variety of forms, some quite subtle, it should be possible to design coverage which would significantly reduce risks facing investors.

[2]As an aside, we note that in many countries, governments have had to take the initiative in establishing financial institutions which, once established, were financially viable on their own. The IFIs would be performing a similar role in this context.

8. Enhancing the Productivity of Foreign Investments

So far, I have focused on what might be done to improve the functioning of capital markets. But there are another set of actions which the developed countries and the IFIs can take to improve the returns on investments, and which in turn may improve the flow of capital.

First, there is a growing recognition of the complementarity between publicly provided capital goods and private investment. Good infra-structure in general and a good transportation system in particular have strong positive effects on the return to private investment. Beyond that, the government can help coordinate the provision of other aspects of infra-structure which may be provided by private investors. Thus, another important ingredient for successful private investment is a good telecommunications system. This is frequently a natural monopoly; and in any cases government regulations will inevitably affect the profitability of private investment.

It goes without saying that

governments in host countries need to provide a favorable environment for investment. But beyond this, governments in developed countries and the IFIs can help take a lead role, in conjunction with the governments of the host countries, in providing (or ensuring that provide firms provide) the physical conditions, the infra-structure, which will enhance the productivity of private investment.

A higher quality and healthier labor force is also likely to enhance the returns on investment. *Governments in the more developed countries as well as the IFIs can provide support for the health and education programs.*

Beyond that,

the governments of the more developed countries and the IFIs can help create an understanding of the ingredients which make for an attractive investment environment-- such as stable macro-economic policies and stable political institutions, with a more

equitable distribution of income contributing to that stability.

Secondly, some of the potentially best investments in the less developed countries are in export sectors. From the perspective of investors in the developed countries, export oriented industries are more easily monitored. There is also accumulating evidence that the successful NICs grew largely on the basis of the expansion of their export industries. But exports for the less developed countries are imports for the more developed countries.

The more developed countries must be willing to allow these imports, with a minimum of restriction—non-tariff barriers as well as tariffs. Providing guarantees to that effect will remove a major source of risk to investing in LDCs.

The International Financial Institutions can play a particularly important role in this respect, providing a mechanism (like GATT) which commits the more developed countries in a way which they may not be able to commit themselves.

Some of the non-tariff barriers, such as those on food, are justified on the basis of health standards.

The more developed countries could provide assistance to ensure that the LDCs can satisfy these standards.

9. Joint Public/Private Ventures

There are a number of areas in which there is an international "public interest," such as in the environment, where

joint ventures between public aid agencies in the developed countries, private firms in the developed countries, and enterprises in the less developed countries might be undertaken.

10. An International Securities and Exchange Commission, International Auditing Standards, and International Rating Agencies

In the early years of the development of equities markets, there were repeated instances of "scandals," scams in which investors were cheated. The effects of these scandals lasted often for years, as investors were scared off from putting their money into equities markets. Information problems, more broadly, are now widely recognized seriously to impair the function of equity, and to a lesser extent, bond markets.

Within developed countries, these problems have been addressed in three ways: establishing a set of regulations attempting to ensure full disclosure and to limit the extent of untoward and fraudulent practices, enforced by a securities and exchange commission; auditing standards, so that outsiders can have a more accurate picture of what is going on inside the firm; and rating agencies, providing outsiders with a professional assessment of the firm.

Some of the countries rapidly growing countries which have been most successful in attracting foreign capital have recognized the importance of these institutions, and have instituted regulatory regimes which has provided assurances, at least to those investors who are sufficiently informed about their practices.

An international convention, setting standards across countries, with compliance monitored by IFIs, and perhaps by the Securities and Exchange Commissions of the United States and other developing countries would provide assurances to investors in the more developed countries that they do not presently have.

Establishing international auditing standards, with auditing done by international auditing firms (with liability extended to investors in source countries and enforceable in courts in the source countries), would likewise prove important, both in establishing a viable equity market within these countries and in attracting foreign investment.

International rating agencies provide ratings comparable to those provided by domestic rating agencies within the developed countries might enable many Institutional investors with fiduciary responsibilities to invest in bonds issues by foreign firms.

11. Concluding Remarks

I believe there is considerable scope for Source Country governments and the International Financial Institution's to promote the private flow of capital to the second tier less developed countries. Within the existing institutional arrangements, there are undoubtedly a number of areas of potential improvement. I have touched upon several institutional innovations which would improve risk sharing, reduce risk to investors or to borrowers, improve the flow of information, and improve the returns to investments in these countries. In the final analysis, I suspect that only by directly attacking these fundamental barriers to the flow of capital will significant and sustained improvements in capital flows be possible.

PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES STRATEGIC PERSPECTIVES EMERGING FROM RECENT WORK IN THE DEVELOPMENT ASSISTANCE COMMITTEE

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The following key orientations flow from the outcome of work over the last few years in the DAC. A set of the agreed conclusions of the relevant DAC meetings is being made available to the Development Committee as a Compendium.

Development Strategies, the Private Sector and the Balance between Official and Private External Financing

The importance of a dynamic private sector to viable development strategies in all parts of the developing work is now accepted Financing the rapid growth of the private sector will create both a need and a basis for a diversified pattern of development financing, domestic and external. As the private sector emphasis is pursued, private capital inflows must and will increase as a share of total external financing, even (and especially) in those countries which are now almost totally reliant on official flows. This link between private sector development and the pattern of external financing should be a core element in policy thinking about the pattern of development financing.

Political and Economic Framework in Developing Countries and the Basic Importance of Credibility

The availability of both domestic and external financing for developing countries depends essentially on the prospects for sustainable, dynamic growth. Sound market-oriented economic policies and good governance are basic requirements for sustainable growth. External suppliers of finance, both official and private, as well as domestic holders of capital, will make their own assessments of economic and political prospects. The credibility of a Government's commitment to sound economic policies and good governance is therefore critical. The experience of a small but growing number of countries shows that such commitment works, as witnessed by renewed access to international lending, growing foreign direct investment, and the return of flight capital.

The Key Role of Domestic Private and Financial Sector Development

Private Sector

A comprehensive medium-term strategy for the development of the private sector is essential as a basis for introducing policy reforms to create a market-oriented economy. Privatization programmes will constitute in many cases an important component of a private sector development strategy.

Financial Sector

A sine quo non of private sector development is the parallel evolution of intermediation services on a market-oriented basis across the whole range of enterprises, from microenterprises to large companies. A growing and diversifying financial sector will create new possibilities for linking into external sources of financing and expertise. In many developing countries notably those with serious dysfunctions of their banking systems, comprehensive reform and rehabilitation of the financial sector is essential.

Microenterprises

A thriving microenterprises sector plays a key role in private and financial sector development and in market-oriented development strategies generally. It is a major source of income and employment for a large portion of the population. Microenterprise development strategies should be based on a "systems approach" to fostering low-cost lending institutions and technologies and cost-effective training schemes for small entrepreneurs. Under a systems approach, microenterprise lending should be linked into mainstream financial sector development, acting to assist both the assembly and the discremination of a national pool of loanable funds, as is conceived in some recent microenterprise support programmes, e.g. by the InterAmerican Development Bank.

Regional Co-operation

Private and financial sector development will require in many parts of the developing world a regional approach which enlarges economic opportunities, generates competition and fosters regional learning networks among enterprises which help to spread successful management and innovatory skills.

Foreign Direct Investment

The best means of attracting foreign direct investment is to create a climate conducive to domestic private investment. The additional requirements needed to attract foreign investors are an open investment regime, equal treatment of foreign and domestic investors, allowing foreign control and up to 100% foreign ownership, and liberalizing foreign exchange regimes. Fiscal incentives and protection should be used sparingly it at all, since they frequently involve a waste of scarce domestic revenues and economic resources. Efforts to promote inward direct investment by the developing countries need to be highly professional, well-targeted and

systematically followed through on the basis of medium term strategies. Such efforts should be coordinated with the activities of counterpart agencies in source countries. There is scope for technical assistance from successful investment promotion agencies in a number of developing countries.

Domestic Regulatory Environment

Private and financial sector development strategies will need to embrace a review and reform of the domestic regulatory environment, to clear away costly and obstructive laws and administrative requirements, while at the same time, strengthening competition and prudential supervision of the finance sector.

The Public Sector

An excessive size and role for the public sector has "crowded out" private and financial sector development in many developing countries. down-sizing the public sector is therefore a necessary, if difficult, priority. At the same time, the role of the state in providing essential "public goods" is very often too weak and will need to be strengthened. These "public goods", which are key to creating an hospitable environment for investment, both domestic and foreign, include the policy framework, law and order, efficient provision of administrative and physical infrastructure, and investment in human capital, i.e. health and education for all.

Coherence of Policies in Source Countries

The work in the DAC, as is clear above, leads to the conclusion that the flow of private capital to developing countries depends fundamentally on factors which go well beyond the narrow financial sphere, where the emphasis too often is given to guarantee schemes and various kinds of subsidized incentives. The essential need is for coherent and comprehensive medium and long-term strategies in both host and source countries. In the source countries some key elements in this context are noted as follows.

a) Macro-economic and Trade policies

OECD countries have yet to adjust their public sector deficits to a level which is compatible with an overall savings surplus available to finance development in non-OECD countries at reasonable real rates of interest. OECD countries have yet to finalize the Uruguay Round, creating uncertainty about the future of the world trading system at a times when many developing countries have liberalized their trade regimes and moved towards outward oriented economic strategies.

b) Debt alleviation and financial supervision

It is difficult for developing countries who have adopted major adjustment and policy reform programmes to make progress with private and financial sector reform if they have debt burdens which are not compatible with becoming credit-worthy in the near future and if financial supervisory

authorities in OECD countries discourage new lending. OECD countries need to recognize more fully this issue of policy coherence as they continue the progress made already in alleviating debt problems.

c) Tied aid credits

OECD countries have adopted measures to increase discipline and limit the use of tied aid credits. The main thrust of these measures is to separate as far as possible tied ODA credits from commercial (export credit) finance in order to ensure that aid funds are truly additional to what the market can provide. The DAC has therefore agreed not to provide tied aid credits to the "better-off" developing countries and (except in the case of LLDCs) for projects which are commercially viable under correct pricing policies and which could attract commercial finance. This agreement is aimed at preventing the diversion of aid from poorer countries and genuine aid needs, and avoiding the situation where aid effectively subsidizes sub-optimal public sector pricing policies in developing countries. The agreement thus envisages greater flows of private capital to sectors and countries where tied aid credits have been usurping their role.

Aid Policies and Aid Co-ordination

The role of aid in encouraging private capital flows to developing countries is essentially indirect rather than direct. Donors must give adequate support to countries adopting structural adjustment and policy reforms and generally committed to creating the environment of sound economic policies and good governance which is the basic source of credibility and confidence,. They can also help in the design and implementation of strategies for private sector and financial sector development. Multilateral and bilateral donors needs to think carefully about the impact of their aid efforts on the balance between the public and private sectors. Finally, they need to improve aid co-ordination in the developing countries to ensure that their efforts to promote private and financial sector development are effective and consistent and to provide adequate and efficient interaction with host country policy makers.

I. Economic performance of Latin America and the Caribbean and external contributions to the region's efforts

In the beginning of the 90s, after a decade of instability in the main economic variables, a broad consensus seems to have been reached in Latin America and the Caribbean concerning economic strategy, and has also begun to spread to some basic aspects of social development.

While some countries seem to have gained a stable growth rate, others --the vast majority-- still face the problems inherent in managing the adjustment. It is encouraging, however, that the most serious inflationary conditions seem to be under control, thereby making it easier to reactivate these economies on more stable bases and enabling them to cope with the serious social problems being faced.

Although, obviously, the solutions for Latin America will not come from outside, the new policies being set in motion by the countries in the region also require a favourable framework of external co-operation. Over the years the Latin American countries have created a great capability for analysis and proposals concerning the various items on the international agenda. Greater consideration and receptiveness of the Latin American initiatives would make it possible to come up with solutions that are in keeping with the needs the region itself has identified.

Unfortunately Latin America's efforts are taking place under especially unfavourable international circumstances, characterised by the recession of the main industrialised economies. The excessive transfer of resources related to the external debt problem persists; protectionist practices are becoming more deeply rooted and there is uncertainty concerning the outcome of the Uruguay Round; prices of the main export products have continued to drop and the terms of trade have deteriorated; there is concern regarding the future prices of hydrocarbons, interest rates, the fate of direct investments, international financial flows and the best means for gaining access to new technologies.

The crucial problem for the Latin American and Caribbean countries over the short and medium term is that of being faced with an unfavourable international context and finding the appropriate external financing to supplement the effort made at the domestic level.

Latin America and the Caribbean must determine how much external financing it can actually expect to receive for development in coming years and what actions the international community could take for these expectations to be feasible.

II. Alternative external financing methods

Elements that should promote investment in Latin America and the Caribbean

Latin American and Caribbean countries will continue to adopt global measures aimed at achieving a macroeconomic balance at the fiscal and external levels, liberalise, deregulate and open up their economies, and establish adequate exchange policies. Likewise, continued efforts will be directed toward the establishment of an infrastructure, education and human resource training.

The furthering of integration is giving rise to broader economic, trade and investment sectors for productive agents within Latin America and the Caribbean as well as for foreign investors. Significant additional effort will be required so that the various bilateral, subregional and regional integration processes converge toward the establishment of a hemispheric area of free trade, offering singular trade and investment opportunities.

Latin America and the Caribbean are developing ample privatisation programmes. These programmes have attracted important levels of external resources, have led to an improvement of the fiscal accounts and, additionally, have allowed former State-owned enterprises that had no possibilities of receiving external credits, to gain access to national and external capital markets once they were privatised.

Once important levels of direct foreign investment and external investment are maintained on a long term basis, the governments of the region will be in a better position to increase social spending, which, in turn, will result in improved human resource training. This training is a decisive factor for the efficiency of internal management and international competitiveness.

Among the tasks to be undertaken by Latin America and the Caribbean, emphasis must be placed on stimulating the creation and development of long-term capital markets, in order to attract and maintain greater amounts of resources to sustain the growth of productive activities.

Latin America and the Caribbean, with the restructuring and economic openness policies being carried out, has become increasingly attractive in terms of opportunities for investment. These policies have led to important reforms in domestic regulations governing foreign investment, and to the signing of a number of international and bilateral agreements on the subject by countries in the region in view of the consideration that the environment for attracting foreign direct investment to Latin America is considered especially favourable. Outstanding among the features of this new policy are the fact that, in general, investments are allowed to enter with no restrictions, greater clarity as to the areas and activities in which foreign interests are allowed, elimination of restrictions on the transfer of dividends and the profits from foreign capital, speedier processing of the applications and paperwork for domestic authorizations permitting foreign companies to take part in productive activities and, moreover, laws and regulations that do away with uncertainty concerning the treatment to which these investments will be subject. In the area of international actions, the most noteworthy are the signing of agreements to eliminate double taxation, the accession by several countries in the region to the World Bank agreements establishing the Multilateral Investment Guarantee Agency (MIGA) and the International Center for the Settlement of Investment-related Disputes (ICSID), and the signing of bilateral agreements with government investment promotion and protection agencies.

II.1 Investment

a) Direct foreign investment

- The harmonisation of industrialised countries' tax systems could help foster flows of direct foreign investment and favour that the recipient countries receive a larger share of the benefits.

- Industrialised countries should set up, within their trade promotion offices in Latin American and Caribbean countries, information schemes on investment opportunities and investment promotion areas in order to link companies in the country of origin and potential markets in recipient countries.

- The International Finance Corporation (IFC) and the Inter-American Investment Corporation (IIC) could promote the efforts made by the countries and the opportunities offered by these countries by organising road shows to inform the international financial community of existing and potential opportunities, emphasising national efforts in this regard.

- The support of multilateral financial organisations is necessary for the structuring of national offices in Latin America and the Caribbean, generating direct foreign investment projects.

b) Privatisations

- Once the disincorporation operations have taken place, privatisation schemes create opportunities for additional financial contributions of private foreign investors for the enterprises' modernisation and technological development.

- In order to ensure greater private sector participation in infrastructure, involving a large volume of resources and long-term projects, the State should carry out two important tasks. The first task would be that the State make complementary investments, which entails external financial contributions. The second task involves the establishment of a transparent and stable regulatory framework thus providing a sound foundation for private initiative.

c) Foreign portfolio investment

- The growing globalisation of the international financial market suggests that the probabilities of future expansion of this type of financing are good. Nevertheless, restrictions and conditions demanded by governments and stock exchanges of industrialised countries could limit access to these markets, particularly the creation of foreign investment funds and the issuance of shares on foreign stock exchanges.

- Although securities' markets have actively developed in Latin America and the Caribbean, attempting to resolve many of the obstacles limiting the offering of shares, the support of multilateral financial organisations is needed in order to develop a mechanism to obtain funds for the region's countries in a less developed stage in this area.

- The external support of multilateral financial institutions is required for the structuring of regionally integrated electronic stock exchanges and the creation of binational stock exchanges.

d) Risk capital financing by specialised organisations

- Industrialised countries' governments could encourage an evaluation and review of MIGA policies to increase and reorient their capacity to provide guarantees and actively promote investment projects.

- Another element of interest is that of intensyfing International Finance Corporation (IFC) and Inter-American Investment Corporation (IIC) coinvestment projects for the execution of projects linked to small and medium-sized businesses.

- It is of interest that both the World Bank and the Inter-American Development Bank review the possibility of granting direct loans to the private sectors of the region, without requiring collateral from the public sector.

- Broad links and greater support for Latin American and Caribbean subregional financing organisations are required of the IFC and IIC in order to stimulate the obtention of investment projects within the region.

e) IDB Multilateral Investment Fund

- Bearing in mind the catalyst role this Fund would play in encouraging the mobilisation of financial flows to the region, contributing countries' prompt compliance with legislative and operating procedures is required in order that the fund may initiate activities as soon as possible.

- The resources of the Multilateral Investment Fund will be destined to granting technical assistance to promote a free market economy in the region. Within this context, particular attention should be granted to the technological modernisation process expected to stem from the direct financial support offered to the joint efforts of the private and public sector.

II.2 Credit and attraction of funding in the international capitals market

a) Long-term commercial bank financing

- Efforts of industrialised countries as well as those of commercial banks must be continued, with the support of international financial organisations, in order to reach arrangements for a larger number of countries of the region leading to a decrease in their external debt and its servicing.

- The governments of industrialised countries should promote the reestablishment of bank loans. This objective could be achieved by making the regulations within the framework of the Bank for International Settlements (BIS) more flexible and establishing different risk categories for countries on the basis of their adjustment efforts and economic behaviour thus reducing bank requirements for the granting of loans to countries of the region, moving closer to the less stringent requirements for operations involving OECD countries.

- Attempt to decrease differences in bank capital requirements under the BIS for short-term loans and those maturing in more than one year.

- Adopt the recommendations required in order that the World Bank and the International Monetary Fund play a more active role vis-à-vis commercial banks, endorsing the efforts of the Latin American and Caribbean countries with adequate economic performance.

- Emphasise the catalyst role of international financial organisations in the area of syndicated bank loans and collateral for transactions.

- With the backing of the IFC and the IIC, establish information mechanisms on legal and regulatory frameworks of the countries of the region in order to improve country and project evaluations made by multilateral financial institutions and agencies specialised in risk classification.

- In the case of niche financing, in which the loans have extraordinary external security, either direct or indirect, providing the lender with protection against the overall risk of the country, it is necessary that multilateral financial institutions review their present negative pledge clause in order to promote this type of investment, providing for the exception of these clauses under carefully specified conditions.

- Uncertainty persists in respect of income from Latin American and Caribbean exports of basic commodities and the continued deterioration of trade terms. In this regard it would be advisable to execute a review of the Compensatory Financing Facility of the IMF in order to ensure sufficient cash flows toward the countries of the region. Likewise, and for these same reasons, financing by the international financial community should be encouraged in those projects where

the repayment is guaranteed at a fixed price of a raw material or by a buyer assured of a percentage of the production of same over a number of years.

b) The bond market

- Opportunities exist for greater participation in bond markets by countries of the region since prior experiences have been satisfactory for the creditors, given the honoring of these obligations both before and after the acute debt crisis. The improved economic indicators of the countries of the region is proof of improved capability to repay these instruments.

- The World Bank and the IDB should broaden their technical assistance in respect of bond placements of countries of the region on international markets and explore options to guarantee issuance of bonds by countries of the region interested in such support.

- The IFC and IIC could co-operate with the countries of the region in the development of bond markets at the national, subregional and regional levels and in the structuring of corresponding legal mechanisms in this regard.

- Both the World Bank and the IDB should offer increased support in order that the reforms and modernisation of the financial systems of the countries in the region be continued.

c) External trade credits

- External trade credits involve high costs and restrictive conditions, requiring that industrialised countries' export credits agencies make their criteria more flexible with regard to the acknowledgement of recent progress of the countries of the region and that they take into account these countries' favourable perspectives for the future, granting case by case treatment similar to that granted to OECD countries.

III. Financing social development

- To further economic development, attract investment and train human resources and thus have a more productive region, it is important that due consideration be given to the initiative which Latin America and the Caribbean placed before the 1991 Annual Meeting of Governors of the World Bank and the IMF, concerning the adoption of a "Joint Programme in Support of the More Vulnerable Sectors," aimed at more in-depth action for social development (See Annexe 1).

ANNEXE

JOINT PROGRAMME IN SUPPORT OF THE MORE VULNERABLE SECTORS

"We wish to propose[1] .... the adoption of a "Joint Programme in Support of the More Vulnerable Sectors," aimed basically at consolidating social development action for the more vulnerable sectors of the population. In implementing this programme, very concrete measures in the area of social policies on the part of the beneficiary governments will be demanded. The Programme should consist of three simultaneous elements:

1. The establishment, at the World Bank, of a "Special Window for Social Projects," with financial terms midway between those of the International Development Association and those of the Bank for medium-income countries, to be used in cofinancing, together with the recipient government and possibly other bilateral and multilateral sources, projects to improve the living standards of the more neglected population groups.

2. A mandatory cofinancing share of no less than 25% of the total cost of the project will be set for the recipient governments. The prerequisite for disbursement of these loans will be the adoption, by means of the appropriate legal instruments, of a "National Programme in Support of the More Vulnerable Sectors," that is to consist of:

- The definition of policies and a percentage of the national budget allocated to education, health and nutrition;

- The restructuring or expansion and improvement of the institutions in charge of the social sector;

- Manpower training in the area of managing educational and health institutions.

- The definition of specific priority projects based on the needs of each country.

3. Simultaneously with this "Special Window" for social projects, a "Permanent Technical Assistance Facility" would be set up, in keeping with the proposal of the Group of 24 developing countries, which could provide nonreimbursable financing from the Bank, the UNDP and from bilateral contributions for implementation of the National Programme suggested above".

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[1] Address by the Governor for Venezuela before the Meeting of the Board of Governors of the World Bank and the IMF, on behalf of the Latin American and Caribbean countries. Bangkok, 15 October 1991.

FOR IMMEDIATE RELEASE

DEVELOPMENT COMMITTEE

JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
ON THE
TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES

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May 1, 1993

COMMUNIQUE

1. The Development Committee held its 46th meeting in Washington DC on May 1, 1993, under the chairmanship of Dr. Ricardo Hausmann of Venezuela. 1/ The Committee recorded its deep regret at the violent death of President Ranasinghe Premadasa and sent its condolences to the Government and people of Sri Lanka.

2. The Committee devoted most of this meeting to an examination of ways of encouraging private capital flows, as part of its ongoing review of the transfer of resources to developing countries. 2/ The Committee reaffirms its belief that a high level of investment in the private sector is important to sustainable economic growth in developing countries. It recognizes that the majority of this investment comes from these countries' domestic savings. Private foreign flows and official development assistance have a complementary but crucial role to play. Private foreign flows have been largely concentrated in a small number of countries. The challenge before the international community now is to enlarge this number as quickly as possible.

3. The Committee notes that host countries have the primary responsibility for creating an environment attractive to foreign investors. This will require a stable political climate and sound macroeconomic policies; a healthy, vigorous and competitive domestic private sector; a legal and institutional framework which encourages investment without discrimination; a liberal exchange regime; a flexible labor market; improved management capacity in the public sector; and provision of the necessary physical and human

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1/ Dr. Hausmann is the Minister of State and the Head of CORDIPLAN in Venezuela. Mr. Lewis Preston, President of the World Bank, Mr. Michel Camdessus, Managing Director of the International Monetary Fund, Mr. Mohammed Imady, Minister of Economy and Foreign Trade of Syria and Chairman of the Group of 24, and Mr. Peter Mountfield, Executive Secretary, took part in the meeting. Observers from a number of international and regional organizations also attended.

2/ For the purpose of this Communique the phrase "developing countries" includes economies in transition.

infrastructure. Prompt servicing of debt will reassure investors. Reduction of the debt overhang, where appropriate, for reforming countries, will also help. Because much investment in developing countries is in export industries, open world markets are essential. Once these measures are in place, which may take time in some countries, funds will tend to flow naturally to profitable ventures.

4. Where unnecessary institutional and regulatory barriers to the supply of such funds remain, the Committee calls on the industrial countries and the international financial institutions to do all they can to remove them, and to catalyze greater volumes of investment. The IFC in particular can help by doing more to support investments in poorer countries with less access to private capital.

Foreign Direct Investment

5. The Committee believes that FDI is the most valuable form of private external finance, since it brings with it access to the technical know-how, managerial expertise and wider markets of the industrial countries. Because it moves in response to perceived market needs, it is much more efficient than state-directed capital flows. It poses less risk to the host country's fiscal or balance of payments position. The Committee welcomes the action taken by most host countries to attract FDI, by reducing discrimination against foreign investors. It also calls on the industrial countries and the international institutions to play their part by providing technical assistance, investment sector lending, fuller information, guarantees and where appropriate financial support.

Portfolio Investment

6. The Committee welcomes the sharp increase in portfolio investment in equities and bonds in several developing countries in recent years. Foreign portfolio investment will add flexibility and depth to domestic capital markets. These markets should be expanded further. The Bank Group and the Fund should provide continuing support for market development, through policy advice, finance and technical assistance. The Committee calls on both industrial and developing countries to speed up the removal of the remaining regulatory and other impediments to portfolio flows, particularly by facilitating the greater participation of institutional investors.

Bond Markets

7. The Committee also welcomes the reform efforts made by several developing countries. These have restored confidence and allowed them to enter or regain access to the international market for bonds and other financial instruments. It encourages the governments of "source" countries to review and address the remaining obstacles which prevent access to their securities markets by creditworthy developing country borrowers.

Commercial bank lending

8. The Committee recognizes that commercial bank lending is not always a suitable form of long-term development finance, or available or appropriate for countries facing severe balance-of-payments deficits. However, the successful resolution of the debt problems of many middle-income developing countries has permitted a small increase in commercial bank lending. The Committee encourages industrial countries which have not already done so to review their regulatory mechanisms and requirements regularly, and in doing so to examine the scope for easing constraints on trade and project finance to developing countries, without weakening proper prudential supervision. It notes the role of the World Bank's Enhanced Cofinancing program in supporting lending.

Private Sector Development

9. The Committee also reviewed a related report by the World Bank Group on its private sector development strategy which also helps to attract more foreign investment. It welcomes the emergence of a new generation of loans through which the World Bank supports policy, regulatory and legal reforms directed at improving the day-to-day environment in which firms operate. It commends the work already done or in hand, while calling on the Bank Group as a whole to make even greater progress by promoting small and medium-scale industry and the entrepreneurial role of women, in encouraging the private sector in developing countries, especially the poorest, and in supporting the necessary underpinning public sector reforms.

Official Flows

10. The Committee recognizes that, for poorer countries and those presently unable to attract sufficient private capital, official development assistance remains essential. It therefore welcomes the completion of the IDA-10 negotiations, and calls on the donor countries to complete the ratification process, so that there is no disruption to commitments. It also calls on the Bank to increase further the focus on poverty reduction and environmentally sustainable development. It welcomes the rapid progress in considering the operational modalities for a successor to the ESAF, the Fund's concessional facility for its poorer members; it urges that this work be completed by November 1993, and calls on the Fund to explore all options for funding. It also notes that a review of the pilot phase, discussions on restructuring, and negotiations for the replenishment of the Global Environment Facility are about to commence; it agrees on the importance of a productive outcome by December 1993. It notes that other negotiations are in hand to replenish the concessional funds of other multilateral agencies, and hopes they can be concluded as soon as possible. It calls on industrial countries to consider further ways of increasing flows of officially supported export finance. Finally, it points to the continued stagnation in flows of official development assistance, despite the increased needs, and invites donor countries to do their best to increase their aid as circumstances permit, particularly where it still falls short of 0.7% of GNP.

Ministers also underscored the critical importance of ODA achieving its intended developmental impact. They called on all donors and recipients to strengthen efforts to improve the quality and effectiveness of assistance. Ministers commended the World Bank's effort to undertake a frank and critical self-evaluation of its project performance, and stressed the importance of a vigorous action program. They also urged all development agencies which have not already done so to undertake similar efforts to improve the development impact of their assistance, and to concentrate aid operations on the poorest countries and those where aid can be most effective.

Trade

11. The Committee records its increasing concern about the continued delays and risk of breakdown in the Uruguay Round negotiations. Failure could easily lead, not to continuation of the status quo, but to a downward spiral of increasing protectionism. This would be extremely serious for the growth of the world economy and particularly for the developing countries, leading to a progressive reduction in the markets for their exports and a consequent fall in the living standards of their citizens. It would weaken the developing countries' resolve to liberalize trade further, and to undertake structural reforms. On the other hand, an early agreement will benefit all countries. The Committee asked that all countries firmly resist protectionist pressures. It calls on all the parties for a prompt and successful conclusion to the Round by the end of 1993, and its early implementation.

Next meeting

12. The Committee agreed to meet again in Washington DC on September 27, 1993, when it will concentrate its discussion on two topics: long-term social policy reforms and short-term safety nets; and adjustment experience in low-income countries and their financing needs. It will also review action taken, or in hand, to follow up the suggestions made at today's meeting.

Appendix A. Agenda for the 46th Meeting of the Development Committee Washington, D.C., May 1, 1993

1. Main Paper for discussion:

   Developing Country Access to Private Capital Flows (DC/93-4) 1/ 2/

2. Progress Reports: (To take note)

   a) Private Sector Development (DC/93-6) 3/

   b) Outcome of the IDA-10 Negotiations 4/

3. Other Business

1/ This joint World Bank/IMF issues paper was requested by the Committee in paragraph 8 of the September 1992 Communique.

2/ The Chairman has commissioned a number of supplementary papers for this item from individual Members and outside experts. These are listed, together with a summary of their main recommendations, in a separate Note by the Secretariat. (DC/93-3)

3/ This report, to be prepared by the World Bank, was requested by the Committee in paragraph 11 of the October 1991 Communique.

4/ This and other recent developments will be covered in the report by the President of the World Bank. (DC/93-5)

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Arab Fund for Economic and Social Development	(AFESD)
Asian Development Bank	(AsDB)
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International Fund for Agricultural Development	(IFAD)
Islamic Development Bank	(IsDB)
Organization for Economic Co-operation and Development	(OECD)
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OPEC Fund for International Development	(OPEC FUND)
United Nations	(UN)
Associates: UNCTAD	(UNCTAD)
UNDP	(UNDP)

Development Committee
(Joint Ministerial Committee of the Boards of Governors
of the World Bank and the International Monetary Fund
on the Transfer of Real Resources to Developing Countries)

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