Finance for Development Impact

SECO's contribution to financial sector strengthening and reform in development and transition countries[1]

SECO Economic Cooperation and Development

"*There is hardly a more conventional subject in economic literature than financial crises*", noted Charles Kindleberger in the preamble of its seminal work on the history of financial crises published 30 years ago. Still, the severity of the 2008 financial crisis which hit some of the most sophisticated financial sectors in the world, took almost everybody by surprise. What is considered the worst financial crisis since the "Great Depression" is redrawing the boundaries between government and markets. Ironically, it is also a sad reminder of the fact that sustained and sustainable growth needs well functioning financial markets, i.e. a resilient international financial infrastructure, sound financial and monetary framework conditions and affordable financing opportunities for private sector investment. The excesses of highly leveraged financial products which led to the 2008 crisis, illustrate how important it is to develop more stable and deeper financial markets contributing to economic development.

Helping to make finance work is therefore as important as ever. It essentially requires preventing markets and governments from failing, while fostering effective allocation of resources. This agenda is at the core of SECO's approach to economic development in partner countries. The purpose of this paper is to outline how SECO intends to contribute with its partners to financial sector reforms in developing and transition economies, building on the experiences of the last 10 years. The paper is structured as follows: Part 1 of this paper provides a brief summary of research findings on the importance of the financial sector for development. An overview of donor strategies and programs is drawn up in Part 2. Part 3 describes the SECO program to date in the sector, and part 4 concludes by offering pointers for the way forward.

Bern, October 2010

[1] The policy note was prepared by Jean-Luc Bernasconi, Thierry Buchs, Matthias Feldmann, Nathalie Floras, Martin Gisiger and Monica Rubiolo.

List of Acronyms

ADB: Asian Development Bank

ADFIAP: Association of Development Finance Institutions in Asia and the Pacific

AFCA: African Venture Capital Association

AML: Anti-Money Laundering

ASEM: Asia Europe Meeting

BIS: Bank for International Settlements

CAC: Collective Action Clause

CEE: Central and Eastern Europe

CIDA: Canadian International Development Agency

CGAP: Consultative Group to assist the Poor

Danida: Danish Ministry of Foreign Affairs

DFIs: Development Finance Institutions

DfID: Department For International Development (United Kingdom)

EBRD: European Bank for Reconstruction and Development

EDFI: European Development Finance Institutions

GDP: Gross Domestic Product

FATF: Financial Action Task Force on Money Laundering

FDRP: Finance and Development Research Program

FIRST Initiative: Financial Sector Reform and Strengthening Initiative

FSAP: Financial Sector Assessment Program

FSDP: Financial Sector Deepening Program (e.g. Tanzania)

FSF: Financial Stability Forum

FSI: Financial Stability Institute (Basel)

FSSA: Financial System Stability Assessments

G10: Group of Ten

GBS: General Budget Support

GIIS: Graduate Institute of International Studies (Geneva)

GTZ: (Deutsche) Gesellschaft für Technische Zusammenarbeit

IAIS: International Association of Insurance Supervisors

IEG: Independent Evaluation Group (WB)

IMF: International Monetary Fund

IBRD: International Bank for Reconstruction and Development

IDA: International Development Association

IFC: International Finance Corporation

IFIs: International Financial Institutions

IOSCO: International Organization of Securities Commissions

JSB: Joint Stock Banks

LIC: Low Income Country

MFI: Microfinance Institution

MIC: Middle Income Country

NBFI: Non-Bank Financial Institution

NFX: Netherlands Financial Sector Development Exchange

OECD: Organization for Economic Development

OTM: Office of Technical Management

PFSP: Partners for Financial Stability Program (USAID)

RIA: Regulatory Impact Analysis

ROSC: Report on Observance of Standards and Codes

SDC: Swiss Agency for Development and Cooperation

SEAF: Small Enterprises Assistance fund

SECO: Swiss State Secretariat for Economic Affairs

SIDA: Swedish Agency for International Development Cooperation

SIFEM: Swiss Investment Fund for Emerging Markets

SME: Small and Medium Enterprises

SNB: Swiss National Bank

SOCB: State Owned Commercial Banks

SWAp: Sector Wide Approach

TA: Technical Assistance

TATP: Technical Assistance and Training Program

WB: World Bank

WDR: World Development Report (WB)

WTO: World Trade Organization

Part one: Understanding the contribution of financial sector to growth and poverty reduction

The dynamics of financial sector development

Financial sector development accelerated during the 1990s on account of financial sector liberalization, technological progress and innovation, resulting in increased financial integration and further changes to the real economy. Underpinned by the increasing globalization of trade and the ensuing raising demand for cross-border financial instruments, the acceleration of global capital mobility has transformed the way financial markets operate. Financial innovation was particularly accentuated over the past years, with the development of structured financial products including derivative instruments. On the one hand, financial innovation has pushed modern finance to new frontiers in terms of credit risk transfers and pricing, but on the other hand, it has also encouraged excessive risk taking and played a significant role in the depth of the global financial crisis of 2008. The move towards market-based financial development has been also strong in developing and transition countries, with an initial focus on liberalization of domestic financial systems and increased capital account liberalization. As for the most recent crisis, although it had the industrialized world at the epicenter, it seems to confirm what have been the major lessons of past episodes: regulatory weaknesses are as responsible for financial crises as regulatory failure, and strong national financial frameworks aligned with proved standards and embedded in international coordination mechanisms remain undisputedly a necessary condition for financial stability. In light of this, it seems appropriate for developing and transition countries to analyze the existing policy prescriptions on the speed and sequencing of financial liberalization and to put a greater emphasis on the enabling environment—e.g., regulatory institutions, legal frameworks, accounting and disclosure practices, debtor information systems, safety nets, creditor rights, and contract enforcement.

The financial sector matters

In recent years a growing body of research has attempted to investigate the complex interactions between financial sector development and economic growth, the role of financial sector in alleviating poverty, and the adequate sequencing of financial sector reforms. Defined as the sum of all wholesale, retail, formal and informal institutions in an economy offering financial services to consumers, businesses and other financial institutions, the "financial sector" includes in its broadest definition everything from banks and stock exchanges, to microfinance institutions[2] and money lenders. The financial sector is at the heart of economic activity and a crucial building block for private sector development. It contributes to achieve and maintain macroeconomic stability, enables secure financial and payment transactions, helps mobilizing domestic and external savings, and fosters the efficient allocation of capital into productive investment.

There is ample empirical literature on the so-called "finance – growth nexus", which indicates that financial development does make an important contribution to economic growth in the long run. *Capital accumulation* is one of the key channels of growth. Developing countries typically need large investments in infrastructure such as water sanitation and roadwork, which require pooling of capital by banks or access to capital markets. Another growth channel is the role of banks in promoting *structural change*, led by technological innovation and productivity gains. Banks tend to lend money more easily to innovative and thus fast growing companies. However, the direction of causation between financial sector

[2] http://europa.eu.int/ISPO/ecommerce/sme/definition.html

development and growth is a complex issue and a given level of development does not preclude financial sector weaknesses. In addition, the finance - growth nexus is less certain in the short run, at least empirically, as evidenced by the impressive number of banking and currency crises in modern economic history. In particular, fast growing emerging markets are especially vulnerable to a financial crisis in the take-off phase, thereby giving rise to well documented boom-bust cycles. Mexico (1995), Thailand (1997), Indonesia and Russia (1998), Turkey (1999) and Argentina (2001) are but some of the most notorious examples where the emerging, developing and transition economies at the root. Although long term benefits and short-term problems are not mutually exclusive, recent financial crises prove that liberalization is not a panacea and that the development of a competitive and efficient banking system takes time.

Financial sector development and poverty reduction

Financial sector development contributes to poverty reduction in different ways. First, the financial sector reduces poverty *directly* by widening access of the poor to financial services, such as through microfinance and small loans. Millions of poor families also rely on money transfers (remittances) from relatives who earn their living abroad. Efficient and reliable financial infrastructure, such as cross-border payment systems, help to reduce transaction costs for these transfers. Furthermore, access to domestic payments systems is often a precondition for drawing on utilities services such as electricity or water. Access to insurance services also helps poor families, who cannot rely on their savings alone in coping with emergencies such as accidents and illness. Second, the financial sector reduces poverty *indirectly* by promoting economic growth, which is widely recognized as a necessary condition for sustained poverty alleviation. Indeed, empirical evidence suggests that incomes of the poor tend to rise (and fall) proportionately with average incomes as a result of growth.

The financial sector plays a crucial role for three categories of economic agents, namely households, corporations and the government. *Households* need basic financial services to become active economic actors. Access to a large array of financial services, such as saving facilities, payment instruments, credit and insurance is crucial in order to optimize consumption over the life cycle. For the *corporate sector*, access to finance is necessary for business expansion and sustainability, in particular through access to longer term funding. This can foster investment into more productive technologies and stimulate job creation. Effective financial intermediation is thus crucial to channel savings into productive investments, finance current expenditures and trade and manage risks. *Monetary and fiscal authorities* rely on the smooth functioning of the financial system. Only deep financial sectors allow them to implement anti-cyclical fiscal policies, thereby giving treasuries access to domestic and/or international savings. Social policies, such as the provision of affordable and adequate housing, benefit from the emergence of a mortgage market that ensues from a well-developed financial market. A strong private insurance sector supplements social insurance. There is also a strong interdependence between central banks and the financial sector. A well-developed banking sector is the foremost transmission channel for monetary policy. This also entails a well functioning payments and securities clearing and settlement system.

Framework conditions for financial sector development

Two general framework conditions must be met for optimal financial sector development, namely a stable environment and an adequate regulatory regime. *Macroeconomic and political stability* are the main ingredients of a stable environment. Prudent monetary policy that maintains price stability provides an adequate signal for investors, savers, producers and consumers. It also discourages dollarization, which may lead to severe currency mismatches between assets and liabilities, thereby increasing liquidity and solvency risks. Fiscal discipline on the other hand reduces the pressure on interest rates and therefore the probability of crowding out the private sector through excessive government borrowing. A

well functioning financial sector needs *strong regulatory and supervisory framework conditions* in order to remedy market failures (such as market abuse arising from information asymmetries or anticompetitive markets resulting from natural monopolies) and promote systemic stability. The development of efficient and effective regulatory framework conditions and supervisory regimes implies (i) restraining market and customer abuse, (ii) setting up prudential solvency rules, (iii) enhancing systemic stability and (iv) providing antitrust rules. As the 2008 financial crisis has shown, a significant segment of the financial market still operates outside any regulations, encouraging regulatory arbitrage. The proper regulation and supervision of the non-bank financial sector (from the insurance sector to hedge funds) is therefore one of the key challenges of the next decade, so as to enable effective risk management and enhance financial stability.[3] Of course, what this crisis has confirmed above all is that we cannot completely prevent crises to occur, but that better regulation can contribute to make them less destructive.

Conclusions

- There is a considerable positive effect of financial sector development on economic growth in the long term. A well-functioning financial sector is essential for private sector-led growth.
- Rapidly growing emerging markets have been across the economic history subject to strong economic downturns due to sudden and severe financial crises. Following such episodes, the costs of restructuring banks and insurance companies and restoring trust into the system are high. Preventing financial crises is crucial in order not to reverse years of economic progress.
- Inherent market failures and imperfections in the financial sector give governments the important role of setting appropriate regulatory framework conditions. Governments need to develop highly specialized institutions to deal efficiently and effectively with market regulation and supervision. They need to focus on the appropriate balance between encouraging financial innovation, supporting the development of broad and deep financial sectors, correcting market imperfections and preserving systemic stability.
- The benefits of financial globalization for developing countries are well known, as are the challenges that go along. For a successful integration to become reality the underlying economic fundamentals need to be strong and local markets need to be properly regulated and supervised. Moreover, the importance of adopting and implementing internationally accepted, country relevant financial sector standards cannot be underestimated. Without reliable framework conditions smaller markets, like those of developing countries, will not be able to benefit from financial globalization.
- Although as the recent crisis shows there are global issues that require a globally coordinated global response, the strengthening of national financial sector systems remains a priority.

[3] See Roubini, N.

Part two: SECO's approach to financial sector support

Aiming at a moving target

Financial sector reform is by definition complex and multifaceted. Financial sector development does not take place in a vacuum, and is entangled with other crucial developments, including business-enabling conditions, capital-intensive undertakings such as the creation of infrastructure (water supply, transport), land and housing, and social policies. Financial sector reforms are complicated because the financial services landscape is particularly dynamic. There have been regular leaps of innovation, followed by heightened competition, which have usually triggered alternating episodes of regulation, deregulation and re-regulation –the latest being just a confirmation to the rule. To some extent markets are also shaped by regulatory conditions and the direction of the causality is not always clear.

It is therefore not surprising that there is still considerable debate as to what constitutes the appropriate speed and sequencing of reforms in the financial sector. Donor agencies have only fairly recently formulated strategies and policies of action, while being active in the financial sector for a long time. In fact, only a handful of donors have comprehensive strategies, with the World Bank (WB) and the International Monetary Fund (IMF) leading. Following the financial crises of the late 1990s, both institutions initiated the Financial Sector Assessment Programs (FSAPs) to help strengthen financial systems in the context of IMF's bilateral surveillance and WB's financial sector development work. The FSAP allows participating countries on a voluntary basis to identify potential weaknesses and to assess the soundness of their financial system against international best practices. FSAPs have therefore become often the starting point for donors to define their support strategies.

The landscape of donor strategies to financial sector development

The financial sector development agenda is large but only a few OECD countries have chosen to be very active donors to low and middle income countries beyond direct funding for Development Finance Institutions (DFIs).[4] Most donors concentrate their support in the area of microfinance or in connection with private sector development,[5] but few countries have publicly committed themselves to broader financial sector support strategies (Germany, Sweden, Switzerland, United Kingdom). Among multilateral institutions, the IMF and the World Bank have set the pace for reforms through the jointly conducted voluntary FSAP programs.

Many standard setting bodies such as the Basel Committee on banking regulation have limited membership. Switzerland is a member of the Financial Stability Board and the G10 group of countries. The latter entails membership of the Basel Committee, the leading international standard setting body in banking regulation. Switzerland as a global financial center has a responsibility in helping to safeguard global financial stability and is interested in endorsing adequate though effective financial market regulation.

[4] Development finance is a specialized sector of the financial industry, which aims to invest in both public and private sector development projects. They play an important role in addressing the investment needs of developing and transition economies

[5] An indicative list is provided below in annex 1.

SECO's channels for financial sector support

Awareness on the impact of financial sector performance on growth has led SECO to engage early in providing financial sector support to its partner countries. Support has been directed to (a) strengthening the international financial architecture and macroeconomic stability; (b) improving the domestic market infrastructure, regulation and supervision; and, (c) financial sector deepening and improving access to financial services. Support can, for instance, generally target lower refinancing costs and better access to global capital markets and know-how transfer in risk management techniques and financial innovation. Technical assistance comes in various forms, such as the establishment of learning centers, the provision of education abroad to supervisors and bankers etc, as well as assistance to ministries of finance responsible for legislation to modernize financial regulation. It can benefit financial intermediaries, different customer segments (the poor, specific sectors), various supervisors (such as insurance or banking) and/or central banks and financial infrastructure providers. It can be targeted at different sub-segments of the market, such as for example leasing, insurance, payment systems, housing finance, microfinance or capital markets.

a) Strengthening the international financial architecture and macroeconomic stability

Macroeconomic stability is seeing a precondition for financial sector development. Support in this area is often of a preventive nature, long term and impact is not immediate. The international financial architecture refers broadly to the framework and set of measures at international level that can help manage financial crises and even prevent them from occurring. The international financial institutions (such as the WB, the IMF, and the regional development banks)[6] are the leading bodies representing the international financial architecture. The IMF is responsible for ensuring the stability of the international monetary and financial system. The Fund seeks to promote economic stability and prevent crises; to help resolve crises when they occur; and to promote growth and alleviate poverty. It has three main functions — surveillance, technical assistance, and lending — to meet these objectives. The wider efforts to reform the international financial architecture involve in particular the Financial Stability Forum (FSF, founded in 1999, transformed in June 2009 into the Financial Stability Board), the Group of Twenty (G20) the Group of Ten (G10) and the various international standard setting bodies such as the International Organization of Securities Commissions IOSCO, the International Association of Insurance Supervisors IAIS, the Financial Action Task Force on Money Laundering FATF and the Basel-based BIS committees. SECO contributes selectively to formulate the Swiss position in these bodies with the objective of reinforcing financial stability and ensuring adequate financial sector regulation. As the financial crisis has shown, however, macroeconomic stability needs also to be addressed at the national level. Adequate monetary and fiscal policies can foster an stable environment enabling financial sector reforms and private sector development. These issues are addressed in the context of the macroeconomic support and of the assistance to Central Banks provided by SECO in selected partner countries.

b) Improving domestic market infrastructure, regulation and supervision

In SECO's approach to financial sector support, market infrastructure includes not only 'hardware and software' systems (such as securities clearing and settlement, gross and retail payment systems, and securities exchanges), but also the information processing and learning institutions,[7] credit bureaus and rating agencies. This definition also covers financial statistics and official financial analysis, which are provided by many central banks. Also more

[6] African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank

[7] Some central banks provide substantial support to learning centres. The Study Centre Gerzensee, a donation by the Swiss National Bank, provides central banker courses on a non-profit basis: http://www.szgerzensee.ch/

"soft" components, such as financial education and training, are important elements of a sound financial sector. The global financial crisis demonstrated that financially educated and well informed citizens can better assess the suitability of financial products and choose in line with their risk profile. Consumer protection and financial literacy together set clear rules of engagement between financial firms and their retail customers. The strengthening of the regulatory framework helps to narrow the knowledge gap between consumers and their financial institutions

SECO strives to support partner countries in designing and implementing regulatory framework conditions and institutions for monitoring the functioning of financial sector market infrastructure that ensure the efficient allocation of resources across the economy and increase the financial system's intermediation capacity in normal times, while decreasing the likelihood and costs of systemic financial crises. Regulation covers a broad set of areas, from banking, insurance, stock exchange, collective investment schemes and pension funds, to anti-money laundering. Regulation may also include self-regulation by industry associations that are endorsed by the supervisory agency. Finally, regulation also includes international standard setting often targeted at ensuring the provision of global public goods (e.g. global financial stability). Supervision is understood to refer to the enforcement of regulation and can be oriented by objectives (e.g. systemic stability, prudential regulation or consumer protection) or by the set of financial intermediaries it addresses (e.g. insurance companies or banks). In some countries such as Switzerland, decentralized supervisory structures exist for some financial market segments (e.g. pension funds, where Cantons have responsibility for the smaller entities and the Federal Office of Social Insurance for superintendence). Financial regulation and supervision is under continuous pressure to adapt. The interaction between markets and regulation goes both ways, regulation shapes markets and markets in turn are influenced by regulation. The development of adequate macro-prudential regulation by national authorities has necessarily to complement efforts for systemic risk monitoring at the international level.

c) Financial sector deepening and improving access to financial services

Since the publication of the seminal *World Development Report* in 1989, there has been a growing recognition of the importance of improving access to financial services for previously "unbanked" segments of the population as a way to create opportunities for people, unleashing entrepreneurship and recognizing the market potential of SMEs. SECO understands *financial sector deepening* as increasing the use and coverage of financial services, both on the savings and the credit side, which requires understanding the needs and characteristics of new consumers, and developing new products and delivery mechanisms.

At the bottom of the pyramid, NGOs, bilateral donors and development institutions have traditionally been very active in developing micro-credit activities, often through highly subsidized schemes. [8]However, scale remains a key issue for the financial sustainability of most microfinance institutions (MFIs) as well as for overall impact. Development finance institutions such as IFC or bilateral donors have played an important role in providing refinancing to the most promising institutions. For example the IFC, as a triple A creditor, has developed the Global Microfinance Facility as a commercially viable approach to provide Microfinance Institutions in Asia, Latin America, Eastern Europe and Africa access to medium term local currency and USD funding from commercial banks. The Facility raises its capital by ways of a three-level securitization, thereby issuing one senior A-tranche and two subordinated B-tranches and C-tranches respectively, and invests those proceeds in sound Microfinance Institutions and intermediate commercial banks (for on-lending to MFI). Several bilateral DFIs including Switzerland's have been part of the first closing and helped create strong demonstration effects on private investors.

---

[8] In this respect, the Multi-Donor Consultative Group to assist the Poor (CGAP) has emerged as leading global initiative, setting best practices for comprehensive microfinance, including rural finance.

On the SME financing side, developing finance institutions like EBRD or IFC (and several bilateral donors) have been providing hard currency credit lines or guarantees to local financial institutions with the aim of facilitate access to finance for new clients, in particular SMEs. In this respect, however, international experiences have been mixed. Indeed, in many developing or emerging markets, SME debt financing is more a question of incentives, local business conditions and credit assessment capacities than a liquidity question *per se*. Even more than debt, the provision of long-term capital funding is certainly the most crucial impediment for SMEs, hence the key role that development finance institutions, such as Switzerland's, play in providing term capital to the SMEs through financial intermediaries such as private equity funds. Their role is proving decisive to crowd in domestic as well as foreign private investors into SME financing.

Lessons learnt from SECO's experience supporting the financial sector

Based on the experience accumulated by SECO over the past years and taking into account the emerging challenges for financial sector development following lessons can be drawn:

i. **Focusing where value added can be generated**: The financial sector is perhaps the most complex sector that development cooperation is dealing with and the relevance and impact of specific instruments are highly context specific. Needs can be differentiated between fast growing emerging markets eager to attract global investors and hence in need of complying with international standards and low income countries which are often completely shut off from global capital due to lack of financial infrastructure. Therefore, adopting a comprehensive or opportunistic approach makes little sense. SECO should continue to focus where it can make a difference, in close coordination with other partners, in alignment with national strategies and taking into consideration the specific local environment and the level of sophistication of the existing financial sector when selecting support modalities.

ii. **Reform willingness is a precondition for financial sector support.** Financial sector reforms are complex and lengthy. A main objective of regulation and supervision is to remedy market inefficiencies. On the other hand financial sector government bodies may also be subject to government failures such as inefficient rent seeking by officials. To be effective the benefits of reforms need to outweigh the cost of regulatory change. Hence, reforms have to be transparent and broadly supported by all main stakeholders with clear understanding of its costs and benefits in order to yield the intended results.

iii. **Financial sector infrastructure cannot be enough emphasized.** The lesson learnt from the Asian economic crisis is that liberalization, in order to be beneficial in the long run, has to be accompanied by a strengthening of the domestic market infrastructure. Without reliable framework conditions smaller markets, like those of developing countries, will not be able to benefit from financial globalization. Developing and strengthening market infrastructure is certainly a complex area of intervention with few proven recipes. All the more have donors to give enough attention to this area.

iv. **Risk sharing with the financial sector is fundamental for efficient resource allocation and sustainable outcomes**. Investment operations, where investment agencies share risks and profits, have proven to be an adequate mode of operation until the desired demonstration effect is achieved. With regards to technical assistance or other incentive mechanisms, the sharing of costs is also a key principle to ensure market readiness for innovation and sustainability.

v. **Partnering up helps to leverage limited resources**. With limited resources, both in financial and human terms, pursuing a pure bilateral approach risks being cost-inefficient and inconsistent with the harmonization objectives Switzerland has adhered to. For *technical assistance* resources should be invested in joint initiatives,

or in programs partnering up with the IFIs or other donors, which have capacity to generate knowledge and policy space. In some case, however, bilateral programs are more efficient solutions (e.g. the TATP) and can generate additional visibility (e.g. Vietnam). For *investment activities*, public investors like SECO still have an important catalytic role to play in mobilizing private investment. Partnering with other DFIs or IFIs helps to attract new private investors (national, international and even Swiss).

vi. **The impact of assistance to the financial sector is manifold.** The impact of policy and regulatory measures affect the real sector and, given the fact that finance is in many of its aspects global or regional, a demonstration effect often extend beyond borders. The lack of access to finance is still one of the major obstacles to growth for most private firms (in particular SMEs) in partner countries. Risks and risk perceptions among local and international investors remain high, especially in low-income countries, and public money is still needed to create strong demonstration effects through innovative mechanisms, be it via the emergence of new types of financial intermediaries, new type of risks taken on by existing financial institutions or the introduction of new refinancing mechanisms. Depending on the objective and instrument, demonstration effects can be noticed i) within a financial intermediary (by accepting to take on new risks on its own account or attracting new investors), ii) within a given market either with the expansion of new products to other local market players with little if no support or with successful new players becoming active actors. Additional efforts should be dedicated to impact measurement in order to account for these effects.

vii. **Exploiting synergies between instruments helps to strengthen coherence**. Different forms of programmatic support, including budget support, offer opportunities and access to participate in a coordinated policy dialogue on economic reforms, of which financial sector reforms should be an integral part. The ultimate long-term objective of budget support is to make countries self-reliant. Since a well functioning financial sector allows countries to tap into domestic and foreign savings financial sector development can be considered as a kind of budget support exit strategy. As another example, building capacity in public debt management (debt management strategies, risk management and primary market development) helps to promote more liquid public debt markets and diversify funding sources in local currency for the private sector. An initiative for middle-income countries is being developed on this subject by the two SECO divisions working on financial sector support, but this type of synergies should be further developed in the future.

viii. **Strengthening the Swiss constituency for financial sector support.** According to past experiences only limited interest and/or capacities could be identified among Swiss financial partners as potential providers of technical assistance, although there is a potential for Swiss investors to be increasingly interested in SECO's related investment operations. SECO should therefore be modest when it comes to the possibilities of mobilizing Swiss content and adhere to the principle of untied support. It remains, however, crucial to develop selectively strategic partnerships with private or public institutions, research and academic centers in order to further strengthen the domestic constituency for financial sector support and increase understanding of the centrality of the financial sector for development.

ix. **Sustainable outcomes require medium-term programs involving extensive local capacity building and outreach**. Financial sector reforms are complex and lengthy. Not only at the macro, but also at the meso and micro level, successful support takes time. Sustained interaction over time with the involvement of local expertise is essential to allow for effective knowledge transfer and capacity building. Transparent and proactive information of local stakeholders on key aspects of a project has proven to be critical for success. Contributing to better financial literacy in partner countries helps to increase impact and effectiveness of financial sector support.

Part three: SECO's experience in financial sector support

Organizational arrangements

The majority of SECO's economic cooperation divisions are directly or indirectly involved with financial sector support activities. This is a reflection of the complex and pervasive inter-linkages between the financial sector and the type of economic activities SECO is promoting in partner countries, ranging from private sector investment and trade to sound fiscal management and transparent regulatory frameworks. The extent of involvement varies, however, and financial sector support generates particularly strong synergies with two of SECO's broader development objectives, namely macroeconomic support and promoting private investments. Accordingly, SECO's financial sector related activities are carried out mainly by the two divisions pursuing these objectives:

(i) **Macroeconomic Support Division**: This division concentrates on strengthening macroeconomic conditions to promote sustainable growth and investment. Financial sector support is targeted at: a) strengthening macroeconomic stability and monetary conditions and b) improving and modernizing the financial market infrastructure, regulation and supervision.

(ii) **Private Sector Development Division**: This division targets the mobilization of capital, know-how and technologies from and for the private sector. Its financial sector support concentrates on: a) extending longer-term finance to the private sector, and b) further deepening of the local financial market.

As already mentioned, other divisions have also undertaken some specific financial sector support activities. In particular, the Multilateral Financial Institutions Division aims at strengthening cooperation with the multilateral development banks. This division provides funding for specific activities of its multilateral partner institutions, mainly through Trust Fund agreements, such as the IFC, respectively EBRD Swiss Consultant Trust Funds.[9] Within the Swiss Administration, other Ministries (Departments) are also active in the field of financial sector support, for instance the *Swiss Agency for Development and Cooperation* (SDC), which is part of the Federal Department of Foreign Affairs and is responsible for the overall coordination of development activities and cooperation with Eastern Europe as well as for humanitarian aid. With its mandate to serve the poor with an emphasis on rural households and agricultural enterprises, SDC supports institutions and innovations that are geared to offer financial services to the poor on a sustainable basis.[10] SDC's involvement in financial sector development focuses on strengthening the capacities of financial institutions especially at the micro level (e.g. training, accountability & governance) and on the development of financial information (e.g. social performance ratings). In this context, SDC also engages selectively in policy dialogue with recipient governments, with the objective to deepen the access of poor households and small enterprises to financial services. SDC also represents Switzerland in CGAP, the Consultative Group to Assist the Poor. SDC and SECO actions in financial sector development are closely coordinated.

The following paragraphs will focus on the programs related to macroeconomic stability and the promotion of private investment, which constitute the bulk of SECO's financial sector support activities.

[9] The Swiss Trust Fund has financed activities such as feasibility studies for Banking Sector Corporate Governance projects (Ukraine, Russia, together with IFC), a Housing Finance study (Egypt, Algeria, also with IFC) or a Seminar on Deposit Insurance for Central Asian and Western Balkan countries (with EBRD).
[10] See www.sdc.admin.ch

a) Financial sector support as contribution to the strengthening of overall macroeconomic framework conditions

SECO's Macroeconomic Support Division focus its financial sector support on partner countries with the objective to achieve sound financial and monetary framework conditions and reform financial market infrastructure. The division strives for a comprehensive dialogue with the partner country on economic policy issues, where financial sector development becomes a crucial component of a sound macroeconomic policy.

Operations are either financed on a bilateral basis or together with other donors and implemented with IFIs, in particular the World Bank and the IMF, and other external partners, including Swiss experts. Sector-wide approaches represent also a promising venue for channeling support to the financial sector (see box 1 below). Interventions are targeted to suit the needs and priorities of beneficiaries and aligned with their financial sector development plans and can feature elements such as policy dialogue and policy advice, direct financial support to government reforms, provision of peripatetic or resident experts, and delivery of trainings and other capacity building measures or combinations thereof. Building up capacities of partner countries in a sustainable manner constitutes a priority for SECO's interventions. Therefore the engagement of suitable local counterparts is essential.

Box 1. Sector-wide approaches in financial sector reform

Sector wide approaches (SWAp) represent an innovative mode of intervention, in which donors support a single sector policy and expenditure program that is led and implemented by the government. Experience from various countries shows that such instruments can result in greater aid effectiveness, reinforce government ownership of reforms, encourage greater coherence and enhance the policy dialogue between government and development partners. Given the complex multi-stakeholder, multi-incentive nature of financial sector development, SWAps are well suited to support financial sector reform.

SECO is supporting the government of Ghana in implementing its Financial Sector Strategic Plan (FINSSP) through a SWAp, together with the World Bank and DfID. The objective is to support the government to perform its role as a facilitator for economic development through strengthening the governance and competitiveness of the financial sector. The program aims at strengthening the supervision and regulation of securities markets, the insurance sector and the banking and NBFI sector and developing sound financial sector policies in areas such as capital markets, pension reform and access to finance, as well as governance frameworks for state influenced financial institutions.

Supporting stabile financial and monetary conditions

In 1992 SECO started multi-country Program on Monetary Policy and Financial Sector Reforms in Developing Countries, the **Central Bank Technical Assistance and Training Program (TATP)**. The program is implemented in cooperation with the International Economics Section of the Graduate Institute of International Development Studies.[11] Special attention is given to foster independent and efficient central banking, which is considered a crucial first step towards sustainable financial sector development. Main activities under the Program are to identify technical assistance needs at central banks, to develop targeted training programs for staff of central banks, to provide support to build the institutional capacities, and to undertake research relevant to countries that embark on financial sector reforms. The program further aims to increase activities at the sub-regional level and facilitate the South-South and North-South exchange of experiences in monetary policy and advice. TATP programs have been launched in several countries. TATP are on-going in Vietnam, Azerbaijan and Peru. In Bolivia and Eritrea the TATP has been closed and in Tanzania it is coming to end.

[11] University of Geneva

Technical assistance for financial and monetary stability is also provided through the IMF. After Switzerland joined the Bretton Woods institutions in 1994 it set up a **technical assistance subaccount** with the IMF for supporting member countries of its constituency at the Bretton Woods institutions to strengthen the macroeconomic framework conditions. The surveillance activity of the IMF in its member countries allows it to identify very specific technical assistance needs. These projects are mainly implemented by the Ministries of Finance and Central Banks. The Subaccount has been recently expanded with a window specially dedicated to SECO's priority countries in the South.

Recognizing the need to monitor and analyze capital flows from and to developing countries, and to design policies to ensure that these flows make the maximum stable contribution to development SECO together with the United Kingdom (DFID) and other donors launched back in 2002 the **Foreign Private Capital Monitoring and Analysis Capacity-Building Programme (CBP)**. The program's goal is to improve the management of foreign private capital in developing countries by building sustainable capacity, supported by high-quality training, advice and advocacy from Regional Organizations (the Banque Centrale des Etats de l'Afrique de l'Ouest; the Banque des Etats de l'Afrique Centrale, the Centro de Estudios Monetarios Latinoamericanos, the Macro-Economic and Financial Management Institute of Eastern and Southern Africa and the West African Institute for Financial and Economic Management).

Modernizing the domestic market infrastructure, financial sector regulation and supervision

Supporting the modernization of financial sector infrastructure and reforming the legal, regulatory, and supervisory frameworks in accordance with relevant global standards and codes constitutes a core pillar of SECO's efforts to strengthen financial sectors of partner countries, support financial sector soundness and the integration into the global financial system.

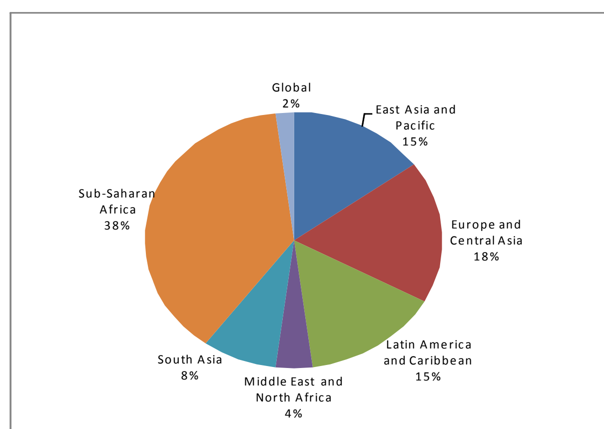
SECO supports the provision of technical assistance in the financial sector by the IMF through regional initiatives, such as the IMF **Regional Technical Assistance Centers (RTACs)**. The RTACs are regionally organized, multi-donor facilities with the objective of assisting partner countries in building institutional and human capacity among others in the domain of financial sector regulation and supervision. In the past years, financial sector supervision was for the RTACs the second most important area of intervention and accounted for around 30% of inputs. Building capacity in financial sector supervision will continue to be a high priority for the RTACs in the future. The objectives will be, among others, to establish common regulatory practices across countries, assist beneficiaries to attain compliance with Basel core standards, develop capital adequacy frameworks and facilitate the transition from compliance-based to risk-based supervision. To date there are six RTACs, two of which are located in Africa and which have been supported by SECO since their inception in 2002. On account of the emergence of sustained macroeconomic challenges and strong demand, the IMF is opening four new centers. For the next phase or RTACs (2010 - 2014) SECO will contribute a total of USD 16 million in support of the existing and new centers in Sub-Saharan Africa and Central Asia.

SECO contributes to financial sector reform through different global initiatives that address the challenges linked to the strengthening market infrastructure. SECO is one of the five bilateral founding member countries of the global **Financial Sector Reform and Strengthening Initiative Initiative (FIRST),** which provides a systematic mechanism for following up recommendations generated by the Financial Sector Assessment Program (FSAP) and the Reports on Observance of Standards and Codes (ROSC). FIRST has been instrumental in designing strategies to implement the recommendations that emerge from these diagnostics. FIRST has established itself as a niche provider of small technical assistance projects and is acting as a catalyst for other donors. FIRST is making a positive contribution to strengthening the international financial architecture through helping countries implement relevant international standards, mitigate the vulnerabilities of financial globalization and maintain the soundness of financial sectors. Since its inception in 2002,

FIRST focused around 44% of support for regulatory and supervisory advice, 19% on strategic, diagnostic and analytical work and around 11% on institutional capacity building and market development (Box 3 below).

Box 3. Financial Sector Reform and Strengthening Initiative (FIRST)

FIRST is a USD 85 million multi-donor initiative whose overall objective is to support growth and poverty reduction in low- and middle-income countries through the promotion of broad, deep, robust and diverse financial sectors. SECO was a founding member of FIRST back in 2002 and has contributed so far USD 24 Mio, being among the largest donors to the program. Other FIRST donors are Canada, Germany, the UK, the Netherlands, Sweden, the World Bank and the IMF. In the past seven years, FIRST has carried out more than 300 projects in 80 countries in the areas of legal, regulatory and supervisory frameworks, financial sector reform strategy and policy advice, market development and institution building, and product development.



FIRST has also evolved taking into account the most recent lessons touching on the financial sector. The global financial crisis, for instance, highlighted the vulnerabilities of countries at all stages of development to shocks that can affect the stability and resilience of their financial systems and led to an increase in demands from developing and emerging economies for support to crisis preparedness and crisis management. FIRST has responded to such demands through rolling-out new **'crisis preparedness' products i**n order to assist countries to develop their capacity to prepare for and mitigate potential future systemic distress and to support post-crisis reform of the financial systems. Under a special funding window, FIRST started 2009 providing technical assistance to help develop and strengthen the intra- and interagency contingency plans of financial sector authorities, including cross-border arrangements, and conducts innovative simulation exercises to test the adequacy of laws, policies, procedures and institutional arrangements and recommend follow-on actions. FIRST also assists countries in implementing reforms, as identified by the review of contingency plans and simulation exercises (such as strengthening deposit insurance schemes or defining procedures for dealing with failing financial institutions.

Since 2009 SECO supports a new initiative in the area of anti-money laundering and combating of terrorism financing (AML/CFT). The IMF **Trust Fund on AML/CFT** is a multi-donor initiative with the objectives to strengthen AML/CFT frameworks on a global level and thereby to protect the integrity and stability of the international financial system and to promote the integration of financial markets and to strengthen national AML/CFT legislation. The Trust Fund works in low-income countries, but also in more advanced economies and countries with large AML/CFT risk exposure, so as to make them compliant with relevant international standards. Technical assistance is delivered mainly through longer-term projects integrating recipients' needs and their implementation capacity.

The **Efficient Securities Markets Institutional Development (ESMID)** initiative aims to develop well functioning local capital markets, in particular corporate bond markets, to

facilitate long-term local currency investments in areas such as housing, infrastructure and microfinance, which are considered critical for sustainable economic growth and poverty reduction. ESMID was initiated as a partnership between the World Bank and IFC with support from the Swedish International Development Cooperation Agency (SIDA) to address the challenges to capital market development in a comprehensive manner Due to the cross-cutting nature of the ESMID program, which covers both financial market infrastructure and regulation and access to finance issues, SECO's Macroeconomic Support cooperates closely with the Private Sector Development division to monitor this program.

In selected countries technical assistance for modernizing the financial sector is provided on a bilateral basis. SECO's widest and longest-standing **bilateral program for the financial sector** is with Vietnam. The financial sector program started in Vietnam in 1997 with a TATP supporting the transformation process of the State Bank of Vietnam and limited scope assistance for the credit departments of the Joint Stock Banks (JSBs). Following Vietnam's membership to the WTO in November 2006 and in response to emerging challenges for integration in the global financial market SECO launched a full-fledged financial sector support program. This program amounting to CHF 9 million consists of different components, including, a) TATP program for the State Bank of Vietnam, b) extensive train-the-trainers program on a range of commercial banking subjects for lecturers of the Banking Universities, c) a management program on banking for a group of senior executives from the state-owned bank sector, d) technical assistance to the Mekong Housing Bank, a small State Owned Commercial Bank, e) capital markets developments through training provided to the lecturers of the State Securities Commission and f) capacity building at JSBs via TA and training.

More recent is the **bilateral program in Peru**. In 2007 a TATP was initiated to advice the management of the Central Bank of Peru (BCRP) in four main areas: (i) Inflation forecasting for monetary policymaking, (ii) real time gross settlement system, (iii) operational and financial risk management and (iv) human resource management system. In 2009 a cooperation has been launched with the Bank Training Institute (*Instituto de Formación Bancaria*, IFB) under supervision of the Banking and Insurance Commission) in the area of financial literacy. Further need for support regarding financial infrastructure development, regulation and supervision has been identified and is being discussed with partners. A similar approach for progressive engagement on a bilateral basis is envisaged for other SECO priority countries.

Partners

SECO works closely with multilateral partners such as the World Bank or the IMF for implementing many of its financial sector activities. In teaming up with these institutions SECO recognizes their role in policy dialogue on financial sector issues and attempts to leverage the available resources while ensuring that coordination with other donors and initiatives is duly addressed. When conducting bilateral support activities SECO intends to mobilize the best suited available expertise, be it at the international, Swiss or local level. Early efforts to mobilize Swiss resources for developing comprehensive bilateral programs in selected partner countries have shown the limitations imposed by a constrained supply base. In effect, while some resources exist in specific areas (such as microfinance or central banking), the potential of mobilizing Swiss partners for mainstream financial sector programs is limited.

Similarly the involvement of the Swiss financial authorities remains limited due to scarce human resources. A notable exception is the Swiss National Bank (SNB), which has expanded their technical assistance programs, mainly in the Bretton Woods constituency countries. SECO and the SNB coordinate their interventions in these countries of common interest. More generally, SECO remains committed to involve the expertise available in the Swiss public and private financial sector as opportunities arise and taking into account the relevance and appropriateness for the particular context of our partner countries.

b) Access to finance and financial deepening related activities

During the 1996-2009 period, SECO's Private Sector Division has financed more than a hundred projects related to financial sector support for total commitments[12] of CHF 0.6 billion, with a sharp increase in activities in the years 2002-2005. The three main objectives pursued by SECO's interventions are extending long-term (equity) finance to the local private sector, further deepening local financial markets, and facilitating the emergence of new financial products.

Extending longer-term finance to the local private sector

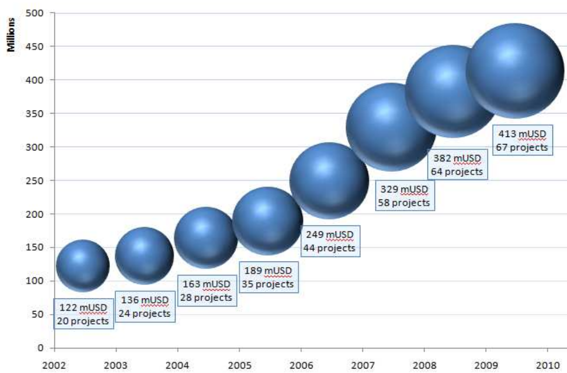
Recognizing that access to long-term finance remains one of the chief growth impediments for private sector firms, SECO is playing an active role in supporting the emergence of a local venture capital industry. This has led SECO to invest regularly in private equity funds (equity participation or quasi-equity participations) on commercial terms mostly targeting unlisted SMEs, alongside other development finance institutions and private investors. Such investments respond to the conditions of subsidiarity (vis-à-vis private investors), additionality, leverage and sustainability. The total commitment volume in the 1996-2009 period is around USD 400 millionsspread out around 70 investment operations. As of 2009, about 35% of the total volume of investments is in emerging Asia, whereas the remainder is spread between Africa (24%), transition countries (20%) and Latin America (16%). Almost 80% of investments are made in the SME sector, 9% in infrastructure and 10% in microfinance (Chart 1 below).The internal rate of return on the total investment portfolio is around 12.5%[13] ,

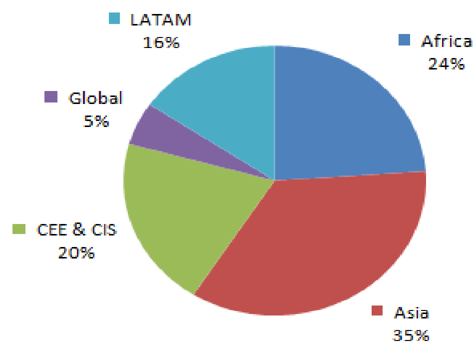
Chart 1. Access to finance related portfolio: investments

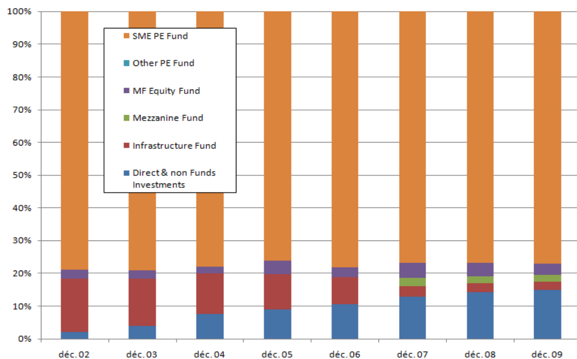
1996-2009

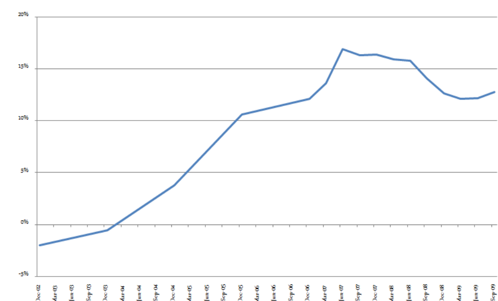
a. Cumulative total project number & volume

b. Geographical concentration (volume)









[12] Total commitments include all investments and projects approved since 1996, including those already exited or terminated and does not take into account any valuation of the current investment portfolio or any currency movement since disbursement.

[13] As of September 2009.

All investments are carried out by SIFEM (*Swiss Investment Fund for Emerging Markets* – *www.sifem.ch*), on behalf of SECO[14].The role of SECO in its investments, like that of other bilateral and multilateral agencies, is to play an important catalyst role to mobilise private funds by creating a strong demonstrative effect. SECO has also been among the *avant-garde* in initiatives aimed at attracting institutional investors and private capital to investment funds active in the field of microfinance, such as the *Global Microfinance Facility* and the *ResponsAbility Microfinance Fund* (Box 5 below).It is to be noted that in the context of its investment activities, SECO also sponsored the development of regional business associations such as the *African Venture Capital Association* (AFCA) and the Emerging Market Private Equity Association (EMPEA) to ensure the dissemination of best practices.

Box 5. Mobilizing private financing for microfinance institutions
The example of *responsAbility*

In the last 10 years, SECO made several innovative investments through SIFEM, providing financial services to micro enterprises, in order to attract institutional and private capital in the field of microfinance. One concrete example is the *responsAbility Global Microfinance Fund* (GMF www.responsability.ch), which was launched in 2003. SECO provided USD 3 million of seed financing, which is half of the initial capital, while four Swiss financial institutions provided the remaining financing. *responsAbility*'s mission is to convey private and institutional capital to promising microfinance institutions (MFIs) in developing countries, and support income generation and sustainable development in those countries. To date, the GMF has extended debt refinancing to more than 100 MFIs mostly in Africa and Central Asia, reaching over 60'000 micro enterprises, which in turn can develop their activities and generate employment. Thanks to SECO's initial seed financing, *responsibility* has been able to attract over USD 100 million of private financing and to reach financial sustainability. Its demonstration role being fulfilled, SECO sold its participation in the Fund in 2006. The earnings of the sale have been reinvested in similar ventures through SIFEM, so as to increase access to finance for SMEs in SECO's partner countries.

From a development point of view, the role of private equity investments is essential given the lack of other alternatives for granting long term financing. However, this role largely goes beyond the field of finance because these investment vehicles tend to promote international standards in terms of accounting systems, transparency and de corporate governance. For that reason, they play an important role in the development of local capital markets, by helping to put financially sound and transparent companies on the market, consequently creating a strong demonstrative effect. Is it possible to measure the effects of these investments on the local economies? That was precisely the aim of a study launched in 2004 and completed in spring 2007 on a sample of 50 SMEs in Eastern Europe and Latin America that had benefited from venture capital investment from the SEAF group. According to the findings of the study, *each dollar invested in a SME via a venture capital fund generates an average of 12 dollars in the local economy*, which reveals an economic return on investment significantly greater than the simple financial return on investment.

Further deepening of local financial markets

In addition to investments in private equity funds, SECO is also providing debt refinancing on commercial terms to existing financial intermediaries in partner countries with a view to support **outreach to new or underserved client**s. These refinancing operations are targeting both banking institutions such as commercial banks interested in down-scaling their lending operations as well as non-banking institutions (e.g. microfinance institutions, leasing institutions) interested in broadening or diversifying their client base. Such investment operations are also carried out by SIFEM (*Swiss Investment Fund for Emerging Markets*) on behalf of SECO and represent 10% of the total investment portfolio.

[14] The *Swiss Investment Fund for Emerging Markets* (Sifem) was established in June 2005 and is headquartered in Bern. It manages SECO's investment portfolio in developing and transitional countries, advises SECO on new investments opportunities and provides, on its behalf, long-term capital for private sector projects in developing and transitional countries.

Facilitating the emergence of new financial products and services

This facilitation role aims at encouraging the emergence of new products and classes of assets, with the help of capacity building and technical assistance. The objective of this targeted assistance is to contribute to risk diversification while offering new financial products in accordance with client's needs (especially MSMEs). Obviously, the extent to which some financial products may be described as "new" depends on the level of market development, but "typical" products in the last 10 years have been *financial leasing, trade finance lines, energy efficiency lines*, as well as *housing loans*. In this context, SECO operates with three categories of intervention:

Financial guarantees (risk sharing), in the context of credit to SMEs, infrastructure projects, trade financing (see Box 7 below). or so-called "green credit lines" This instrument has been used to share the risks on a *pari passu* basis with financial intermediaries with a view to increase lending operations. During the 1996-2009 period, this instrument has been used about 10 different projects for a total of CHF 60 million.

Box 7. Trade Finance: two concrete examples

Risk-sharing in transition economies - SECO participates in the *Trade Facilitation Program* (TFP) of the *European Bank for Reconstruction and Development* (EBRD), which helps promote trade with South-Eastern European and CIS countries. Through this program established in 1999, the EBRD extends guarantees to international banks to cover local banks' trade financing activities. Such guarantees cover the political as well as commercial risks of local banks in the EBRD client countries, and risks are shared between the EBRD, Switzerland and other donors funding the instrument. Risk-sharing funds are used by the TFP to mitigate risk and enable the bank to extend larger limits and longer terms than it would normally be able to do. For instance, Swiss funds have been used to finance TFP activities in Central Asia (€3.2 million) and in South-Eastern Europe (€4.2 million).

Responding to the financial crisis - The 2008 financial crisis and resulting credit crunch have exacerbated the shortfall of available trade finance worldwide. Organic and fair-trade farming products organized along sustainable supply chains in developing countries are particularly vulnerable to the credit crunch. This has prompted SECO to provide a €3 million guarantee to the *TRIODOS Sustainable Trade Fund*, which was launched in 2009 with the aim of supporting the development of fair trade and organic farming by creating access to seasonal trade finance for farmer cooperatives and specialized sourcing companies in developing and transition countries. The loans provided are bridging the cooperatives' and sourcing companies' cash-flow deficit from harvest time till final payment by the buyers, many of which are large retailers in Europe including in Switzerland. The TRIODOS Fund expects to disburse up to €35 million of trade finance loans by 2011.

Technical assistance for developing or introducing new financial products or tools for the local financial infrastructure. Typical examples include leasing (see Box 8 below) and housing finance. These projects typically combine *feasibility studies* for innovative products, *business environment reforms* at the legal or regulatory level (e.g. leasing code, collateral laws, foreclosure law), *capacity building* with financial intermediaries as well as *awareness raising of all stakeholders* (e.g. business associations, clients). SECO financed around 20 projects during the 1996-2009 period. SECO is also active in supporting concrete initiatives aiming at strengthening the local financial infrastructure in partner countries, for instance in promoting the development of credit bureaux and collateral registries.

Box 8. Developing the leasing market in Ghana

In Ghana, the leasing market has experienced a phenomenal growth over the past few years driven primarily by bank lessors, but also as the result of a SECO-IFC leasing program that started in February 2006. Leasing activities in Ghana may have existed as far back as 1978 when a bank lessor was registered as a leasing company. In 2006, when the SECO-IFC leasing program started, the challenge was to support the transformation of competition resulting from the increased number of actors on the market in a real increase of leased asset portfolio. The SECO-IFC program aimed to develop the leasing market as a financing mechanisms for SMEs in Ghana by *improving the legislative framework for leasing, building capacity & improving understanding in the industry, increasing public awareness and interest, creating opportunities for increased investment*, and last but not least, *strengthening the Ghana Association of Leasing companies (GALCO).* Between beginning of 2006 and 2008, the number of lessors increased from 7 to 17, the value of leases in the country increased from USD 15m to 93m, and the number of leases from 311 to 1381. By developing leasing, smaller entrepreneurs can become more economically active subsequently access to income-producing assets. As a financial instrument, leasing has played a crucial role in stimulating investment in productive assets all over the world.

Strengthening risk management capacities of financial intermediaries. SECO has niche activities to improve risk management, most notably in the field of *integrated risk management systems*[15] and *corporate governance* Indeed, at a time when the world faces the worst economic crisis in 80 years, corporate governance is emerging as a core element of the policy toolkit to restore financial stability. SECO is working actively in this field through its partnership with the *Global Corporate Governance Forum*[16] based in Washington DC.

Partners

Since 2005, SECO's investments are managed through a dedicated fund management company, SIFEM (www.sifem.ch), which in turn is partnering with other multilateral and bilateral Development Financial Institutions and fund management companies around common investment projects and coordination institutions (e.g. EDFI; AVCA). In this respect, SIFEM is also increasingly involved with Swiss financial institutions acting as co-investors or follow-up investors.

For other pilot financing projects (e.g. financial guarantees) where the development impact largely surpasses the financial perspective, SECO often operates as a direct financial partner, either on a pure bilateral basis in partnering with a local financial intermediary or together with other risk taking development agencies.

As far as technical assistance projects are concerned, SECO operates mostly through projects or programs developed and executed by multilateral agencies (e.g. IFC, EBRD, FIAS) and selected private partners while recipients usually appreciate a neutral approach (independent from other national architectures).

A network of specialized consultants is being built both internationally and in Switzerland to support its operations either on the design and implementation or the monitoring and evaluation phases. For example, fields of expertise concerned are venture capital, housing finance or risk management.

[15] SECO supports the Risk Management Technical Assistance Facility implemented by OMTRIX in Latin America since 2007. The Facility addresses the growing demand from Micro Finance Institutions (MFI) to better manage financial and operational risks.
[16] www.gcgf.org/

Part four: The Way Forward

Continuing with a two-pronged approach

SECO's approach to financial sector support relies on work conducted in several priority partner countries both, in the South and the East[17], and more than ten years of experience. SECO's two-pronged approach pursuing complementary objectives of macroeconomic stability and financial soundness, as well as promoting private sector investment through broadening access to finance has proved to be both relevant and appropriate for the needs of partner countries, not at least after the most recent financial crisis. This approach should thus be continued, even though this continuity does not preclude a critical examination from time to time to confirm its validity. Stable, sound and efficient financial markets will develop if countries and donors can correct the typical market failures that characterize the financial sector, while avoiding equally typical government failures of macroeconomic mismanagement, inadequate regulations or excessive distortions. For this to happen a periodic strategic reassessment is required.

Main directions for the future

Based on the experience with different initiatives, the lessons learnt from past and current interventions outlined in Part Two of this paper and taking into account the most recent experiences in terms of financial crises and crises responses, we outline below what SECO considers to be important directions for future work.

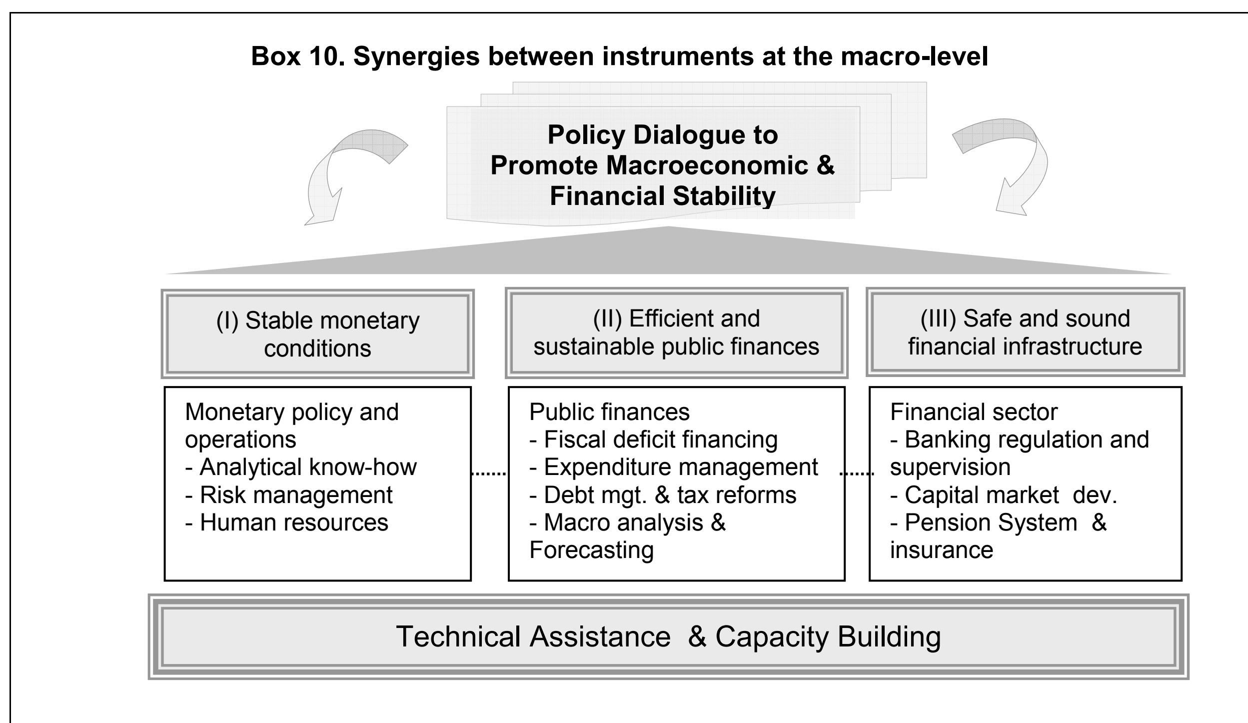
a) International financial architecture, macroeconomic stability and domestic financial market infrastructure

Participation in the dialogue to strengthen the international financial architecture will remain an important pre-condition to better target and design interventions at country level for supporting macroeconomic stability and developing the local market infrastructure. In addition to this international. In addition to supporting the coherence of the Swiss position in this area, SECO intends to underline few elements in future interventions:

- The macroeconomic framework conditions related to the financial sector (monetary and financial soundness) need to be strengthened early in the sector's development process and maintained over time. Experience has shown that gains from financial sector development can be rapidly threatened as the market develops. SECO will therefore reinforce its capacity building program with central banks, in close coordination with the Swiss National Bank.
- SECO should support a coordinated approach to financial sector reforms. The policy dialogue in financial sector reforms is complex and lengthy and involves multiple stakeholders, e.g. customers, ministries of finance, central banks, intermediaries, international organizations and standard setters. Regulatory reforms often imply structural changes with winners and losers. Transparency and predictability of reforms can best be guaranteed by broad consultation and coordination between stakeholders. Stakeholder confidence building in markets, regulators and supervisors implies partnering up with other donors and IFIs, not least to leverage resources and know-how. Supporting multi-donor comprehensive reform efforts at the country-level (SWAps or programmatic approaches) is one option when conditions are appropriate.
- Capacity building efforts should ideally be leveraged through a more comprehensive dialogue on public sector policies. This means in practice that SECO's financial sector

[17] See http://www.seco-cooperation.admin.ch/laender

support programs should as far as possible exploit synergies with other instruments, such as budget support (at general or sector level), public financial management assistance or debt management and relief.



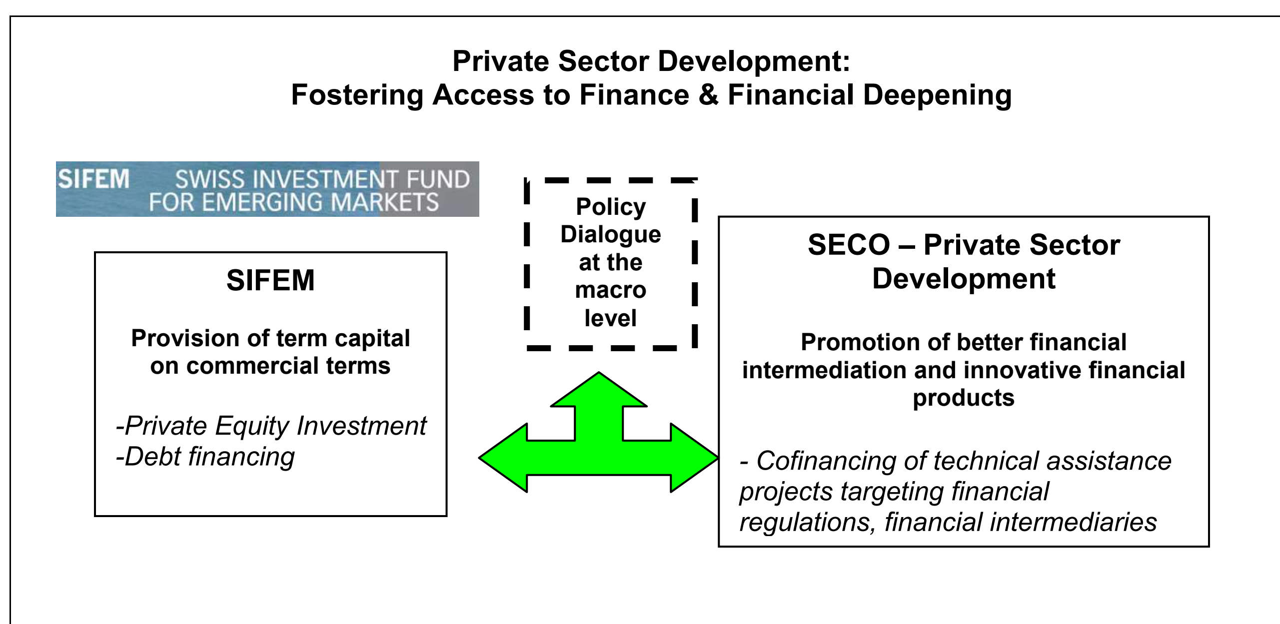
- Given the privileged relationship with countries from the Swiss constituency at the Bretton Woods Institutions and hence their strategic importance, this group of countries will be further targeted. In doing this cooperation and coordination with other interested parties, such as the SNB, should be exploited.
- Building up and strengthening regulatory infrastructure needs to take into account the particular features of emerging markets. These specificities are increasingly highlighted and considered in FSAPs, for example. Therefore, programs such as FIRST, designed to accompany the implementation of FSAP recommendations, are ideally placed to deploy economies of scale by replicating successful institution building while allowing sufficient flexibility to account for regional or local specificities.
- Providing TA in this area is very resource intensive and requires expertise that is not widely available. Know-how tends to be concentrated in a few consultancies, international standard setters, international financial institutions and supervisors. SECO should strengthen cooperation with selected Swiss organizations with proven expertise in the financial sector. SECO can also support research in areas such as regulatory impact analysis and the sequencing of financial sector reforms to help advance the financial sector reform agenda.
- There is a considerable research agenda related to the strengthening of financial sector framework conditions in the pipeline, for which broader donor commitment is needed. The potential of financial innovation is still not fully explored. There are also still considerable gaps in available data regarding access to financial services in developing countries. Sequencing of reforms and impact of international standards on market development are other important research areas, as well as regulatory impact analysis for developing countries.

b) Financial sector deepening and improving access to financial services

The past strong emphasis on access to equity finance by SMEs is expected to be better balanced over the longer run by extending successful pilot activities addressing the access to credit issues, be it through SIFEM or through technical assistance.

While future projects will continue to serve the 3 existing purposes i.e. 1) extending longer-term finance to the local private sector, 2) extending outreach to new client segments and 3) facilitating the emergence of new financial products and services, SECO's fields of intervention are expected to further integrate some foreseeable developments, which include:

- Securing a viable long-term growth of the financial sector through efficient intermediation: While addressing the issue of SMEs access to finance through financial intermediaries, SECO intends to address more extensively the increased concern over the long-term development capacity of formal financial institutions. This includes the access to resources (e.g. savings/deposits or refinancing through the local market) as well as overall management issues (e.g. balance sheet and credit risk management, corporate governance).
- Innovative approaches in the case of least developed countries: Where the financial sector is of a too minimal size and efficiency to trigger or support the development of economic activity, innovative ways to promote the traditional role of the financial market (transaction support through adequate means of payment and traditional intermediation through saving and credit) remain to be developed. If micro lending has been a topic over the past, access to efficient means to enact transactions seems a priority. It concerns primarily the capacity to support *1) trade transactions* and *2) means of payment and saving products especially designed for the poorer/frontier segments.*
- mobilize and channel private capital from OECD countries to the SME sector of partner countries: The challenge here is to develop or identify some successful investment vehicles and continue to leverage private capital, to the benefit of partner countries.
- Leveraging private finance to help the poor: An increasing number of private investors, foundations and institutional investors are seeking investment opportunities, which would provide a combination of financial and social returns.



SECO will also further explore opportunities in specific financial sector support niches, such as anti-money laundering regulation or remittances. Program efficiency, effectiveness and synergies with other programs will be the main guidance in this respect.

Key principles for intervention

- Because of the complex interactions between the legal and regulatory environment and the overall efficiency of the financial sector, **closer coordination** in the sector reform process should be aimed for to reach sustainable results and avoid duplication with other on-going efforts.
- **Constant innovation and adaptation** is required to respond to a fast moving environment. Projects will be selected and designed according to the specific country situation (level of development and financial infrastructure) and the ways and means to deliver assistance will be constantly reviewed to strike a balance between the stimulation of required developments, mainly through demonstration effects, while avoiding or minimizing possible market distortions.
- A **targeted approach in tapping into the Swiss resource base** should include a number of partnerships (e.g. SNB, university research centers) in relation to technical assistance while intensifying efforts to leverage the investment capacity of Swiss financial institutions. Public Private Partnerships in infrastructure projects also allow for the mobilization of capital for countries, normally excluded from global capital markets.
- **Multi-donor or IFIs programs** will be supported whenever the coordination elements or access to specific know-resources are identified as key elements for success (e.g. FIRST)
- **Risk and cost sharing with the private financial sector** will remain a key element. SECO's experience with technical assistance programs benefiting to private financial intermediaries suggests that appropriate pricing of technical assistance is essential so as to avoid market distortions.

Selected Readings and References

Acemoglu D., Zilibotti F., "Was Prometheus Unbound By Chance? Risk, Diversification and Growth", 1997, Journal of Political Economy, 10, pp. 709-751

Barth J.R., Caprio G., Levine R., "Rethinking Bank Regulation: Till Angels Govern", Cambridge University Press 2005

Beck T., Levine R., "Legal Institutions and Financial Development", Handbook of Institutional Economics, 251 – 278, 2005 Springer

Beck T., de la Torre A., "The Basic Analytics of Access to Financial Services", October 2006, World Bank Policy Research Working Paper 4026

Beim D., Calomiris C., "Emerging Financial Markets", McGraw-Hill, New York, 2001

Bossone B., Honohan P., Long M., "Policy for Small Financial Systems", Financial Sector Discussion Paper No. 6 The World Bank, February 2001

Claessens S., Access to Financial Services: A Review of the Issues and Public Policy Objectives", World Bank Policy Research Working Paper 3589, May 2005

Daumont R., Le Gall F., Leroux F., "Banking in Sub-Saharan Africa : What went wrong ?", April 2004, IMF Working Paper WP/04/55

ECB International Relations Committee Task Force, "Managing Financial Crises in Emerging Market Economies: Experience with the Involvement of Private Sector Creditors", July 2005, Occasional Paper Series No 32

Fell J., and Schinasi G., Assessing Financial Stability: Exploring the Boundaries of Analysis", National Institute Economic Review No. 192 April 2005

Goodhart C., Hartmann Ph., Llewellyn D., Rojas-Suarez L., "Financial Regulation: Why, how and where now?" Routledge 2001 4th edition, published in association with the Bank of England

Hoggarth Glenn, Reis Ricardo and Saporta Victoria (2001) Costs of banking system instability: some empirical evidence, Journal of Banking and Finance, Vol. 26

Karadacag C., Sundararajan V., Elliott J., "Managing Risks in Financial Market Development: The Role of Sequencing", June 2003, IMF Working Paper WP/03/116

Kindleberger, C. "Manias, Panics, And Crashes: A History Of Financial Crises", John Wiley & Sons, New York, 1979.

Kose A., Prasad E., Rogoff K., and Wei S-J., "Financial Globalization: A Reappraisal", IMF Working Paper August 2006 WP/06/189

Levine R., "Finance and Growth: Theory and Evidence", September 2004 NBER Working Paper No. 10766

Llewellyn D., The Economic Rationale for Financial Regulation, April 1999, FSA Occasional Paper Series No 1

Loayza N., Rancière R., "Financial Development, Financial Fragility, and Growth", Journal of Money, Credit and Banking, Vol. 38, No. 4, June 2006

OECD An extract from "Promoting Pro-Poor Growth – Private Sector Development" OECD Development Assistance Committee (DAC) 2006

Rajan, R., L. Zingales,. Financial Systems, Industrial Structure, and Growth, Oxford Review of Economic Policy Vol. 17 (2001)

Rodrik D., "Growth Strategies", NBER Working Paper No. 1050, 2004

Roubini, N. “Financial Crises, Financial Stability and Reform: Supervision and Regulation of Financial Systems in a world of Financial Globalization” in The Financial Development Report 2008, World Economic Forum.

Rousseau P.L., “Historical Perspectives on Financial Development and Economic Growth”, 2003, The Federal Reserve Bank of St. Louis

The World Bank, Honohan P., Beck T. “Making Finance Work for Africa, November 2006"