THE ROLE OF FINANCIAL SERVICES IN ALLEVIATING POVERTY
AND
DELIVERING ECONOMIC ADVANCEMENT IN DEVELOPING COUNTRIES/EMERGING MARKETS

Executive Summary

Financial activity is real activity insofar as it takes the “raw material” of money and converts it into different types of assets which are designed to fulfil a number of critical economic purposes. For example, it provides:

- a mechanism for the accumulation of savings and channelling of them into investments;
- a vehicle through which governments and private enterprises can raise capital; and
- a means for governments and enterprises to hedge most forms of price and trading risks.

In this way, financial activity boosts growth and alleviates poverty by delivering economic advancement.

The current political agenda on alleviating poverty and delivering economic advancement in developing countries is based on aid and debt restructuring. This paper draws on the conclusion that financial activity is real activity and puts forward a set of recommendations which focus on mobilising resources around the need to enhance financial activity – an approach which is more in line with changes in the global economy, the shift from command to market economies (and the demise of price cartels and central state subsidy) and the needs of the developing world in the 21st Century (particularly against the backcloth of global liberalisation).

Aid provides temporary relief. In order to secure aid effectiveness, it is important to provide additional resources to increase the productive and absorptive capacity of developing countries. The World Bank has the mission of global poverty reduction and the improvement of living standards. To that end, it provides grants for education, infrastructure and communications, as well as low interest loans and interest free credit. The IMF’s mission includes promoting sustainable growth and reduction in poverty, and it has a medium term strategy to help emerging markets meet the challenges of the 21st century and deal with massive movements of capital and abrupt shifts in comparative advantage.

The world has changed over the past decade and will change further. UK government policies will need to change with it. Six years have passed since the Millennium Development Goals were agreed. The international community recognises the importance of development issues and the UK is expected to play a more active role reflecting its capacity to be an effective, efficient and relevant partner for developing countries.

Today, the major role of financial services lies in the provision of capital and know how for Foreign Direct Investments. The UK is already a major source of Foreign Direct Investments (FDI) to developing countries with total investments of more than £40 billion per annum. Africa, Asia and South America are currently receiving about 1%, 4% and 6% of FDI outflows respectively.

With the exception of sub-Saharan Africa and a small number of countries in Asia, most of the emerging markets have made great strides over the last 10 years or more, driven by the trade opportunities provided by globalisation, the move by formerly communist or socialist governments to adopt market economies and investment by developed country investors. Whilst sub-Saharan Africa has recently shown more encouraging growth rates of 5.5%-6%, this is from a tiny base, and political instability on the continent plus poor governance, together with very small financial services capacity, has prevented these countries from matching the performance of Latin America, Eastern Europe and most of Asia.

Sustainable growth in developing countries and emerging markets is possible only through real businesses. What they need is know-how and funds for investments, access to financial markets and institutions, and legal and regulatory frameworks that lay the foundations for sound and profitable commercial activity. They also need the operation of credible and efficient financial markets. The World Bank has invested in a project which they refer to as “outreach” to develop indicators of access to financial services around the world and thus understand the differences in economic outcomes. The UK is also well placed to provide high value input into all these areas.

Developing countries also need exposure to international markets to raise funds, lower their cost of capital and promote growth. London is a global financial centre with a unique and very experienced cluster of financial institutions, markets and skilled labour. London is thus well placed to assist developing countries in providing them access to international markets and expertise. In addition to facilitating international market access for governments and enterprises in developing countries, it is important that, where appropriate and necessary for their economic growth, that they are assisted in establishing their own markets. Here again, the UK's global role and expertise can play a key part in helping developing countries to attain this objective.

The UK Government needs therefore to develop a "financial activity" road map which is realistic, long-term and sustainable, and meets the requirements of the developing world in terms of reducing poverty and advancing economic development in the new millennium. Set out below are some suggestions which could provide the basis for such a road map.

1. General

1. Growth in developing countries relies more on growth in financial activity than official aid. The UK may be in a position to increase aid to hit the UN targets but as important would be for the UK to encourage access to financial services and/or focus its aid on helping the growth of financial services capability and infrastructure, as otherwise aid alone has temporary effect. Whilst it is doing some of this, it is relatively limited and targeted on a small number of quite successful countries.

2. The UK has an internationally recognised legal and regulatory framework, a well-established infrastructure and a global reach that is of proven success in linking financial activity to investment, business and commerce. The UK Government could provide resources for, inter alia, the Bank of England, the Financial Services Authority and the new Institute for Financial Regulation, co-ordinated by DFID, to grow their international roles in terms of assisting in the training of key staff in the treasuries, central banks, regulatory agencies and key market structures, particularly exchanges of developing countries (e.g. through secondment, courses and qualifications and, in this way, provide high value input in helping developing countries establish an effective legislative and institutional infrastructure).

3. The UK Government should consider stimulating the provision of assistance in very poor developing countries by supporting and incentivising UK-based financial services firms to provide the necessary expertise and investment, inter alia, through the provision of tax relief.

4. The impact of the cycle of economic growth and recession can have a major impact on the effective management of commercial, trading and investment risk. The credibility of financial markets and services is heavily dependant on the capacity of enterprises being able to manage market, credit, legal, liquidity and operational risk during periods of transition and volatility. The UK Government should consider how best to support and stimulate the provision of risk management training of key staff in enterprises and financial service providers, particularly identifying critically important gaps where training is not being delivered.

2. Specific

1. Developing countries need legal frameworks which protect financial trading and investment, properly functioning commercial courts that are not corrupt and a critical mass of their own nationals with legal expertise. The UK Government could consider providing funding for advice on the creation of the necessary legislation and regulations in developing countries, as it did in Eastern Europe in the 1990s. It could also consider providing funding for the training of commercial lawyers, judges and courts. This might include scholarships and bursaries to law schools here in the UK, but also the sponsorship of law schools in the developing country concerned. UK judges could be asked to mentor a judge at the same level in a developing country and funds provided for exchange visits. Government funding could be provided to top up judicial salaries to reduce the vulnerability of judges to corruption.

2. The UK's Financial Services Authority (FSA) is a recognised "thought leader" in the regulation of financial markets, insofar as it was the first major regulator to unify its regulatory structure under one organisation and to introduce the concept of principles- and risk-based regulation. The UK has

considerable experience and expertise in this area, which could be imparted to newly-established regulatory authorities and, as previously indicated, this would be an ideal role for the new Institute for Financial Regulation. In this instance, the recommendation is that the Institute must focus on newly-emerging regulatory authorities, where the risk of failure is at its highest and the consequences for the financial services sector potentially severe.

3. In many developing countries and emerging economies, the Central Bank is still responsible for regulating banks and often has a particular focus on prudential regulation. The Bank of England has been running a successful course, but it is important to ensure that, bearing in mind that the Bank no longer has that supervisory role, the course itself delivers on the need for banking and prudential regulation expertise. This will be particularly important for central banks in developing countries and emerging markets. If the content is solely reflective of the Bank's role as it now is, supplementary training of central bank officials may need to be introduced, either as an adjunct to, or as part of the existing Bank of England course.

4. Market confidence and integrity are critical to the good standing of stock and financial and commodity derivatives exchanges. There is, therefore, a powerful international 'market good' that calls for exchange directors, managers and key staff to be properly trained to run markets to the highest international standards in market and trading practice. The development and delivery of such a course would not only increase the international attraction of such markets, but also maximise their ability to meet the capital-raising, risk management and investment needs of the countries in which they are located. Government funding could be provided to enable such a course to be developed and provided for senior officials and managers responsible for the operation of stock and financial and commodity derivative exchanges – and it is understood that such a course is in the process of development.

5. The ability of corporate market users and financial service institutions to manage market, credit, liquidity, operational and legal risk is critically important to market confidence and integrity, as well as the reputation of a financial services centre. Reference has already been made to this point. It is recommended that the Government undertake some form of analysis to identify where there are gaps in the provision of risk management training for enterprises using financial markets and how best to ensure that sponsored training in this area is provided.

6. Funding could also be provided to expand the Chevening Scholarship programme for not only prospective lawyers, but also people interested in a finance career. The UK has some of the leading business schools in the world providing a wide range of finance degrees. Its professional qualifications are respected around the world. In addition to providing scholarships and bursaries to a country's top students, it could sponsor business schools in the country concerned and partner with UK professional associations to arrange for the delivery of local training and qualifications

7. Another brake on investor interest in Africa would appear to be the lack of financial and economic data. A "chicken and egg" situation would appear to exist where global data providers do not provide financial and economic data because of a lack of demand, yet it is precisely that lack of data that exacerbates risk and generates lack of interest –and therefore of demand. The UK Government, through a DFID supported entity, Finmark Trust, is supporting data gathering in relation to retail financial markets. It would clearly be helpful if it could provide know-how and funding to help develop statistical bodies focused on the wholesale markets in the least developed countries, and then work with the data providers in the City to gather, collate and publicise financial and economic data on these countries.

8. Specifically, the UK Government could examine, with leading City firms, the possibility of creating multi-issuer bonds, possibly in partnership with the African Development Bank, which would create an effective sovereign bond curve to meet the comprehensive pricing needs of private sector firms and, by listing on the London Stock Exchange, the World's largest international exchange, would provide access to large pools of international capital as well as visibility.

9. Finally, the UK Government could assist these countries in reducing the vulnerability of local banks to non performing loans by advising on and funding the creation of credit reference agencies and advising on the creation of guidelines for valuing assets used to secure loans.