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A. CLASSIFICATION

☒ Meeting Material
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B. SUBJECT: SPEAKING ENGAGEMENT: CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY // JDW TO MAKE SPEECH // (B) NOTE: CAROLINE TO MEET JDW AT MACCOSH HALL / ROOM 50
VENUE: PRINCETON UNIVERSITY - MACCOSH HALL / ROOM 50
CONTACT: MS. SUSAN SIMONELLI @ 609-258-5765
PROGRAM:

5:00 P.M. - JDW TO MAKE SPEECH (VENUE: AT MACCOSH HALL / ROOM 50)

6:00 P.M. - COCKTAILS & Q&A (VENUE: PROSPECT HOUSE)

(B) SPEAKING POINTS -- CAROLINE ANSTEY

EXC: CA // ALI

Brief Includes:

- Talking Points from Caroline Anstey
- "The Emerging Markets and Private Equity" from Richard Frank, extracts from a speech to the ING Barings Global Partners Meeting, April 10, 1997
- "Private Capital Flows to Developing Countries"
- Press Release No. 97/27, October 1, 1996, "IFC Announces Initiative to Reach New Markets" sent by Mark Constantine
- "Financial Stability in Emerging Market Economies"
- SecM97-328: "Joint Statement by the President of the World Bank and the Managing Director of the World Bank and the Managing Director of the IMF on Collaboration in Strengthening Financial Sectors", April 27, 1997
- Letter to JDW from Susan B. Simonelli, March 11, 1997
- "The World Bank & New Jersey: Partners in Development"
- Thank you note to JDW from Alan Binder and Harvey Rosen (July 8, 1997)

DATE: 05/02/97

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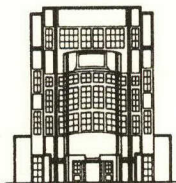
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TO: James Wolfensohn

FROM: Alan Blinder and Harvey Rosen

RE: "Opportunities and Risks in Emerging Markets"

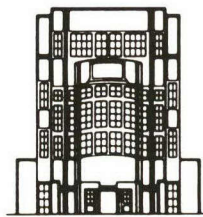
DATE: July 8, 1997

Thank you again for your participation in the May 2-3, 1997 CEPS symposium, "Opportunities and Risks in Emerging Markets." We are pleased to enclose a summary of the proceedings.

If you would like additional copies, please contact CEPS Assistant Director, Susan Simonelli, at (609) 258-5765.

Encl.





Center for Economic Policy Studies Symposium Report No. 15

Spring 1997 Symposium Opportunities and Risks in Emerging Markets

Princeton University's Center for Economic Policy Studies held its fifteenth semi-annual symposium on May 2-3, 1997. The topic was *Opportunities and Risks in Emerging Markets*, and experts shared their views on sources of opportunities and sources of risk, actual experiences in emerging markets, regional outlooks, and portfolio investment strategies.

Keynote Address: James B. Wolfensohn, President of the World Bank. Mr. Wolfensohn's speech was one of a series of lectures associated with the celebration of Princeton's 250th anniversary.

"Opportunities in the developing world are enormous," James Wolfensohn said, and one of the main reasons is the tremendous expansion of the market economy around the world. Ten years ago, it extended to 1 billion people, now it extends to 5 billion. During that time, private sector investment in emerging markets has risen from \$44 billion to \$244 billion.

Wolfensohn pointed out, however, that of the \$244 billion flowing into the developing world, 75 percent of the money is going to 12 countries; and 140 countries receive less than 5 percent of it. He said that "there has to be a better sense of social equity," a better distribution from the rich to the poor. The developing world is not "another world, it is *our world*," Wolfensohn argued, and we are very closely linked with it.

In addition to the strong economic links -- the developing world now accounts for 20 percent of the world's GDP -- Wolfensohn pointed out that we are strongly connected with the developing world through environmental and health issues, inadequate world food supplies,



James Wolfensohn delivers the keynote address.

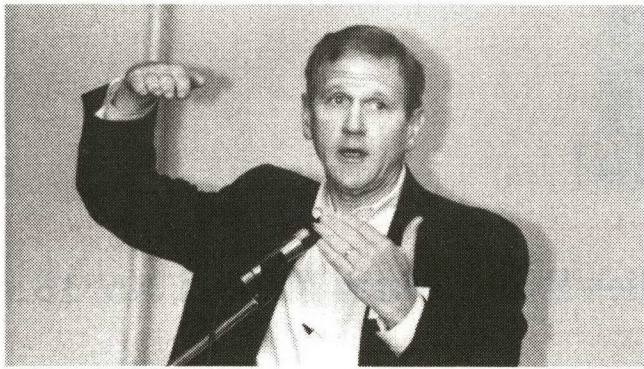
People in the developing world do not want charity, they want opportunity.

migration, and war and crime. "We all breathe the same air, and we can be impacted by the lack of biodiversity," Wolfensohn said. "Migration doesn't recognize any bounds. It is a function of poverty and dislocation."

People in the developing world do not want charity, Wolfensohn said, they want *opportunities*, such as those provided by the World Bank's microcredit program (when small amounts of money are loaned to individuals and communities with no credit history). He called for better partnerships between official institutions like the World Bank, the private sector, and, "most importantly," between the governments and the new "civil societies" of these countries. "If you're going to have sustainability and continuity, you have to be sure that you have these pieced together."



Alan Blinder and George Suter.



Chuck Clough discusses sources of opportunity and risk.

Sources of Opportunity, Sources of Risk: Charles Clough, Jr., Chief Investment Strategist at Merrill Lynch, and David Hale, Chief Global Economist at Zurich Insurance Group.

The world is awash in liquidity, said Charles Clough. While investors chase the high level growth seen in emerging markets, the capital projects they finance must be able to generate enough cash flow to service the debt. The inability of many projects to do so puts stress on the banking systems in many of the developing countries.

Such stress is evident in the Asian Tigers, Thailand, Taiwan, Singapore and Korea, Clough said, as economic growth in those countries is slowing. "Everybody is trying to export the same computer components to the same customer."

The capital-seeking investment in the emerging world is only going to explode to levels far greater than many of these economies can absorb.

Clough also pointed out the relatively small size of many of the emerging market economies. At no time was this more apparent, Clough said, than when he met with Dominigo Cavallo, Argentina's then finance minister, in March 1995. Cavallo said \$2 billion in emergency loans from the IMF would carry the country through August. In the U.S., \$2 billion is a "rounding error," Clough said. "What it showed me is how small many of these markets are relative to the pile of liquidity that exists around the world."

David Hale said the 1990s have brought exciting new stories in the emerging market phenomenon. The first of those stories is the expansion of free-trade policies that previously focused on the developed world under the Global Agreement on Tariffs and Trade but now include the developing world under the new World Trade Organization. There are still many gaps in the new trade framework, Hale said, but there is no doubt that it represents "a major breakthrough in the right direction."

The second story is the introduction of pension funds in a number of developing countries. The most celebrated example is Chile, where the introduction of a private pension system 10 years ago has had a very positive impact on savings and has helped bring most of the population into the stock market. Pension funds have also enjoyed success in Argentina, Singapore, Malaysia, and

From the Co-Director

"I'm interested in globalization issues. Is CEPS the right organization for me?" I get this question all the time. The answer is pretty simple. CEPS focuses on economic policy issues that are important to members of the business, government, and academic communities.



Given the way today's international markets are linked, one generally cannot do a thorough job of studying any economic policy problem without considering such international links. Hence, while our mission is not to study international issues and globalization per se, people interested in such issues will find that CEPS is the right organization for them.

A good example is the spring 1997 symposium on *Opportunities and Risks in Emerging Markets*. Understanding how investors decide how much to invest in U.S. companies is critical to evaluating and predicting American economic performance. However, such investment decisions are made by individuals who are considering investments from all over the world, including emerging markets. As my colleague Burt Malkiel demonstrated during his talk, these days an efficient portfolio requires participation in these markets. Hence, developments in countries abroad will have ramifications here at home, ramifications that can have major effects on our economy.

In other sessions, we learned about the practical problems that firms doing business in emerging markets face. These aren't the kinds of things one can learn about in textbooks or the newspapers. It was altogether a fascinating symposium.

We look forward to seeing you at future events.

Sincerely,

Harvey S. Rosen, Co-Director

southern Africa. And several other countries are considering compulsory retirement systems.

The growth of pension funds spurs growth in the capital markets. "The countries which on the whole tend to have the highest ratios of stock market capitalization to GDP also have very high ratios of pension fund assets to GDP and pension assets to household savings," Hale said.

The final story is the development of new capital markets as more financial centers build the infrastructure of stock brokerage firms, trading, and investment banking.

But there are dangers that pose serious challenges in emerging markets, Hale warned. The first is trade tension. For example, if the U.S.

There is no country on the planet which is not a candidate for some form of portfolio investment.



Nancy Newcomb and Hank Rentschler.

denied China its Most Favored Nation status, the Hong Kong stock market would suffer a major jolt. Second, the lack of regulatory supervision in developing countries could lead to a crisis far worse than the U.S. savings and loan debacle. Despite these risks, Hale said, the outlook for investing in emerging markets is still "quite positive."

Members Forum: Experiences in Emerging Markets: **James Cullen**, Vice Chairman of Bell Atlantic, **Nancy Newcomb**, Customer Group Executive in Global Relationship Banking at Citibank, and **George Suter**, Vice President, International, at Pfizer Inc.

Considering that two-thirds of the world's population has never made a phone call, and one-half of it lives a two-day walk from the nearest phone line, "the best days are still ahead" for the \$500 billion global telecommunications business, **James Cullen** said.

Bell Atlantic's main investment priorities are to enter the long distance market, to increase its datacommunications business, and to develop more sophisticated video technologies. "Successful competitors in the global market may be strong regional companies, but

There are several countries in which we made exploratory investments, developed relationships, and backed out of quickly because of the FCPA.

they will no longer be just local exchange companies, just long distance, just cable, or just wireless."

Developing strong, reliable local partners and adhering to the Foreign Corrupt Practices Act (which prohibits U.S. companies from bribing foreign governments) is central to Bell Atlantic's emerging market investment strategy. "There are several countries, Brazil, Indonesia, and to some extent our concerns in China, in which we made exploratory investments, developed relationships, and backed out of quickly because of the FCPA," Cullen said. He called the FCPA a "plus for us" because it makes "absolutely clear" what Bell Atlantic's corporate policies are.

According to **Nancy Newcomb**, Citibank's global presence extends to 98 countries, 75 of which are in emerging markets. "One of the most important single countries outside the U.S. for Citibank is Argentina," she

said. Citibank's assets in Argentina total \$6 billion, revenues from Citibank operations in Argentina were up 26 percent in 1996, and the outlook for 1997 is very good.

To gain such a prominent local presence, Citibank typically enters a country in its early stages of development to provide its local customers with basic services such as cash management and short term foreign currency loans. As

Demand for global and regional financial products is increasing.

the country grows, and trade and economic development become more important, Citibank offers trade services and project finance. When countries such as Argentina, Indonesia, and Poland enter the "take off stage," more sophisticated services such as securities custody and loan syndications are provided. And finally, when countries such as Chile and the Asian Tigers are "maturing," a "full array of products" are brought in to assist local companies with their own globalization plans.

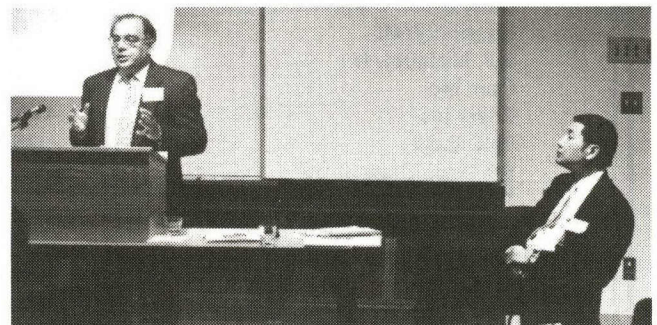
George Suter agreed with Cullen that one of the greatest challenges investors in emerging markets face is adapting to government policies which frequently change "in mid-stream" after the initial investment is made. "Incentives disappear overnight," Suter said. And when undo requests for bribes occur, he also has "found it to my advantage that the FCPA exists."

Another major area of dispute, Suter said, is the lack of protection for intellectual property, patents, and trademarks in many countries, particularly China, India and Argentina. By ignoring intellectual property rights, he explained, governments provide protection to their local pharmaceutical industry.

By ignoring intellectual property rights, governments protect their local pharmaceutical industry.

Related to this is the exclusion of foreign pharmaceutical products on governments' reimbursement lists, the lists of medicines the governments will reimburse their citizens for. This is a major problem in China, Suter said, and it greatly reduces the market potential for their products.

Regional Outlooks -- China and Latin America: **Nelson An-ping Chang**, President of Chia Hsin Cement Corporation, and **Suhas Ketkar**, Director and Co-Head of Global Emerging Markets Economics at Credit Suisse First Boston.



Suhas Ketkar discusses opportunities in Latin America as Nelson Chang looks on.

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The People's Republic of China, Taiwan and Hong Kong make up the fifth largest economy in the world. And within that world, Hong Kong is facing imminent changes, **Nelson Chang** said. As the July 1st British handover approaches, Chang predicted a smooth transition. But in the long run, "changes will be big. At least it is virtually certain that Hong Kong's current status and market economy will not last another fifty years, as stipulated in the agreement between London and Beijing."

Even though it is in Beijing's best interest to maintain the status quo in Hong Kong, things are bound to change. "I don't believe even Washington would be able to manage Hong Kong as it is today, let alone a regime that has known nothing but authoritarian control by a central government," Chang said. "There is only one Hong Kong in this world."

Hong Kong's current status and market economy will not last another fifty years, as stipulated in the agreement between London and Beijing.

While Hong Kong has never been autonomous or democratic, those conditions were not necessary for its success. Chang said. Three conditions that contributed to Hong Kong's success have been: freedom of information, free movement of capital, and free movement of people. Beijing's new law on subversion and a measure to roll back Hong Kong's Bill of Rights will impose self-censorship if not outright censorship. "Any hindrance of the free flow of information will slowly but surely move people and capital out," Chang said.

Chang also believes that Beijing's plan to make the mainland's currency, the renminbi, a freely convertible currency such as the Hong Kong dollar could cause chaos.

Finally on the free movement of people, Beijing will issue new passports to Hong Kongers who declare their allegiance to the PRC. Will these passports be accepted internationally? Those who do not declare they are PRC citizens will be considered foreigners who will have to apply for new resident and work permits. Mainland Chinese will still need travel permits to visit Hong Kong. Will those who want to see and share the former British colony's prosperity accept this condition for another 50 years? These are just some of the questions that remain to be answered, Chang said.

Despite recent U.S. Fed tightening, **Suhas Ketkar** "remains positive" on Latin America's debt and equity markets because growth in the region is expected to accelerate this year to 4.5 percent, and inflation should drop to single or the low double digits in all countries.

He believes that "fears of a repeat of the 1994 debt crisis in Latin America are "misplaced." First, the region's "economic fundamentals, in particular the size of the current account deficits and its financing," are in much better shape now than they were at the end of 1993. Second, monetary tightening in the industrial world in 1997 is likely to be limited to the U.S., and Latin American countries have learned to tap non-dollar capital markets. Roughly 35 percent of new bond issuance in the region in 1996 was in currencies other than the U.S. dollar. Third, countries like Argentina and Mexico with large borrowing requirements have already made "significant forays" into international capital markets ahead of the U.S. rate hikes.

Fears of a repeat of the 1994 debt crisis in Latin America are misplaced.



John Allison asks a question from the audience.

"Argentina has already borrowed about two-thirds of its original \$8.5 billion in funding requirements from the global markets, while Mexico has less than \$500 million left in its market-based borrowing program." And finally, Ketkar believes there is no longer any doubt about the region's commitment to market-oriented economic policies.

Portfolio Investment Strategies: Burton Malkiel, of Princeton University.

Burt Malkiel said that by far the greatest growth and total returns that investors can project today are located in the world's emerging markets.

Despite criticism that the law of diminishing returns will dampen already strong growth in the world's emerging markets, Malkiel believes that even the most pessimistic analysts must admit that growth in countries just beginning the process of development will continue to outstrip growth in the developed world. First, centrally planned economies are being liberated by the adoption of free-market policies throughout the developing world. Second, abundant labor pools, low labor costs, strong work ethics and reasonably high literacy rates are distinct competitive advantages in world markets. Third, free-trade agreements and the transfer of technology and capital provide emerging markets with the tools to develop rapidly. And fourth, high savings rates will augment that flow of capital enabling those countries to make the investments they need in infrastructure and business.

In addition to greater growth potential, Malkiel said the emerging markets offer a second attraction for investors -- low valuations. Price/earnings ratios are lower and growth potentials higher for companies in the emerging markets compared with companies in the developed world. According to Malkiel's research, the P/E ratio for a company based in the developing world was likely to be lower than the P/E for a comparable company in the same industry based in the developed world. "The fact of the matter is in the emerging markets you get higher growth and lower P/Es," Malkiel said.

The advantage of paying a low multiple of earnings for high growth is twofold. As the company's earnings potential is realized, the P/E may rise, putting a higher valuation on higher earnings. Moreover, low P/E stocks can be safer. If a high growth, high P/E stock suffers an earnings setback, investors may sell heavily, as both the earnings and the P/E multiple fall.

While emerging market investing offers these potential benefits, Malkiel said, "all is not perfect. The risks are enormous and I wouldn't underestimate them." They include: unstable political situations, weak legal systems and accounting standards, pervasive corruption, currency fluctuations, and the potential rise of religious fundamentalism. And with these risks comes unprecedented volatility.

But, Malkiel said, with very few exceptions the risks posed by investing in one emerging market are not present in other emerging markets. An investment program that diversifies a portfolio among different countries can reduce these "specific" risks. A diversified portfolio of uncorrelated assets can achieve higher returns given the same amount of risk as a portfolio of highly correlated assets.

An often overlooked way to diversify an emerging-markets portfolio is indexing. Critics of indexing argue that a manager should be able to find undiscovered nuggets of value in countries where information is poor in quality and not widely disseminated. The best stocks may not be included in the indexes.

Malkiel believes it is precisely the *inefficiency* of these markets that recommends indexing. Emerging markets are characterized by illiquidity. The spreads between the bid and offer prices are enormous; trading a large block will move the market away from the price a manager desires. In addition, transaction costs are so high, Malkiel said, "they are likely to offset any advantage that the active manager might gain." Matching a portfolio to an index such as the Morgan Stanley Emerging Markets Index, Malkiel said, promises the same return as the market at lower costs.

By far the greatest growth and total returns that investors can project today are located in the world's emerging markets.

Indexing a portfolio of emerging markets investments does have one important drawback, Malkiel said. A typical international index may leave investors overweighted in a country that has experienced a speculative bubble. This can result because indices typically weight each individual nation based on the overall value of all stocks in its market. The larger the market the greater the weight given to that country.

Malkiel argued that an index weighted according to the size of each country's GDP would overcome that problem. He therefore recommends indexing with modification. Underrepresented countries should be added to the portfolio according to their GDP weights. One can achieve exposure proportionate to economic size by purchasing closed-end country funds, Malkiel said. These funds are country-specific vehicles whose shares trade on exchanges. Often those shares are priced at substantial discounts to the underlying values of the assets in the funds, allowing investors to increase their exposure to underrepresented markets at bargain prices.

CEPS Symposium: Princeton, May 2-3, 1997
"Opportunities and Risks in Emerging Markets"

Friday

Public keynote address by **James D. Wolfensohn**, President of the World Bank, followed by dinner at Prospect House for CEPS members and Symposium Participants

Saturday

Sources of Opportunity, Sources of Risk

David Hale, Chief Global Economist, Zurich Insurance Group
Charles Clough, Jr., Chief Investment Strategist, Merrill Lynch

Members Forum: Experiences in Emerging Markets

James Cullen, Vice Chairman, Bell Atlantic
Nancy Newcomb, Customer Group Executive, Global Relationship Banking, Citibank
George Suter, Vice President, International, Consumer Health Care, Pfizer Inc

Regional Outlooks -- China and Latin America

Nelson An-Ping Chang, President, Chia Hsin Cement Corporation
Suhas Ketkar, Director and Co-head of Global Emerging Markets Economics, Credit Suisse First Boston

Portfolio Investment Strategies

Burton Malkiel, Princeton University

Tentative Program
CEPS Symposium: Princeton, October 17-18, 1997
"The Future of Social Security"

Friday

Keynote address by **Michael Boskin**, Stanford University, former Chairman of the Council of Economic Advisers, to follow dinner at Prospect House for CEPS members and Symposium Participants

Saturday

Current Status of Social Security

Laurence Kotlikoff, Boston University
Alicia Munnell, Member, Council of Economic Advisers
Martha Phillips, Executive Director, Concord Coalition

Economic Effects of Social Security

Barry Bosworth, Senior Fellow, The Brookings Institution
Harvey Rosen, Princeton University

Reforming Social Security

Edward Gramlich, University of Michigan, and Chairman, Advisory Council on Social Security
Henry Aaron, Senior Fellow, The Brookings Institution

The Politics of Reforming Social Security

John Hille, Assistant to the President, Director of Legislative Affairs
Peter Passell, The New York Times

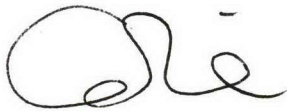
Princeton

Mr. Wolfensohn:

They would like you to speak for 30-35 minutes and then take Q and A. I enclose talking points, background information and a list of those who will attend the cocktail party. (You have agreed to attend cocktails before going to the IAS dinner across campus).

I also enclose 2 briefs on the Bank's involvement with building capital markets, financial sector reform etc.

FYI, the latest figure the Bank is citing for private capital flows in 1996 is \$244 billion.

A handwritten signature in black ink, appearing to be 'Caroline', with a large loop at the start and a small dash above the end.

Caroline
4/30/97

James D. Wolfensohn
Public Lecture in conjunction with the Symposium on
Opportunities and Risks in Emerging Markets
Center for Economic Policy Studies,
Princeton University
May 2 1997

Introduction and Thanks

- Alan Blinder
- Harvey Rosen
- 250 years ago when Princeton was founded, Colonial America was the quintessential emerging market - over the next 40 years - amidst revolution and nation-forming - its population of barely a million quadrupled and the value of its exports and imports trebled.

The opportunities today are enormous

- Striking as was that growth pace, what we are witnessing in many parts of the globe today is even more dramatic. In 1747 it took people and information 3 months to cross from Europe to the United States. Today technological change and particularly the computer are rendering borders and time increasingly obsolete. As a result:
 - international companies can now disperse production worldwide while keeping tight day-by-day control.
 - segmented national financial markets have been transformed into a single global finance market characterized by an enormous pool of highly mobile funds.
 - and global trade flows in the last 12 years have doubled. More than 120 countries are now formally committed to trade liberalization as members of the WTO. Last year global trade exceeded \$6 trillion.
- Combine this with rapid *marketization* - the fact that roughly 5 billion people now live in market economies compared with 1 billion a decade ago - and a global trend towards *democratization* - sixty-one percent of the world's 191 countries are formal democracies compared with forty-one percent of countries 10 years ago - and the qualitative change that has taken place over the last 15 years is remarkable.

Within this global dynamism nowhere are opportunities greater than in the developing world

- Between 1991 and 1996 developing countries accounted for half of the growth in global GDP and 40% of the growth in world trade. The Bank estimates that by the year 2010 they will consume 40% of all goods and services the world produces.
- And developing countries will continue to grow at an average rate of 5-6% a year into the next decade, double that of the major industrial countries.

Private capital is already reflecting that reality

- The strongest testimony to the dynamism of emerging markets is the huge financial commitment which private parties around the globe are making in developing countries.
- In 1996, private capital flows to emerging economies were nearly six times their level in 1990 - up from just \$44 billion then to \$244 billion last year - *almost 4 times the peak reached during the 1978-82 commercial bank lending boom.*
- Private capital flows now dwarf official flows, accounting for more than 86% of net long-term flows to developing countries.
- And the nature of these flows has changed in 2 important ways:
- Recipients and borrowers within developing countries are no longer primarily governments - borrowing by the public sector now accounts for less than one fifth of total private flows. In effect, dramatic privatization is underway.
- And there's been a notable broadening in the composition of private capital flows. Traditional commercial bank lending used to account for more than 65% of all private flows. Today, FDI (about \$109 billion) has emerged as the most important component of private capital flows. And portfolio flows - both bonds and equities - from a negligible level in 1989, now account for 30 % of total private capital flows.
- The stimulus to growth from these private flows is powerful - whereas foreign private capital inflows were equivalent to less than 4% of domestic investment in 1990, that has grown to almost 17% last year.

So are emerging stock markets

- Today over sixty developing countries have stock markets compared with half that number in 1986.
- The number of domestic companies listed on the stock exchanges of emerging markets more than doubled from around 11,000 ten years ago to over 22,000 today.
- And significantly, a good many of you in this room probably have, or soon will have, a more direct financial stake in emerging economies than you realize - US pension fund commitments to emerging markets are now forecast to grow some

- 25% per year, compared to growth of commitments to the developed market of only 15%.
- With total assets of over \$5 trillion, US pensions represent a potentially huge source of new money for developing countries (they would also provide the longer-term capital that would help reduce volatility and improve efficiency in the developing markets).

But if these are the opportunities, what are the risks?

- more than 100 developing countries having suffered some kind of serious banking crisis since 1980 - often with disastrous and costly consequences (recent analysis suggests that 5 countries in Africa have had to spend more than a tenth of their GDP to fix the damage.)
- most of the major developing country recipients of private capital still have a limited macroeconomic track record, weak financial sectors, and ill-developed capital markets.
- Over the next 2 days the Center for Economic Policy Studies Symposium will focus on issues of volatility, overheating, banking regulation, and crisis management. Given the range of experts you have focusing on these issues, I do not want to preempt them tonight. Let me just say that the Bank Group is devoting an increasing amount of its time to financial sector issues through a 2-pronged strategy:
 - improving the overall macroeconomic environment;
 - building up the financial strength of local markets, so that they can withstand the shock of international flows of funds

In the last 3 years, the Bank Group has approved \$8.6 billion of loans and investments in the financial sector:

- developing well functioning capital markets - Bank and IFC began to build bond and equity markets in Hungary as far back as 1985. IFC developed the first global investment fund for emerging markets: the Emerging Markets Growth Fund, in 1986, which started at less than \$50 million and has now grown to \$9 billion - annual returns in excess of 26%.
- fixing banking systems. Russia, \$200 million technical assistance loan - to build the capacity of 25 core private commercial banks. Over past 2 years, Bank has committed nearly \$3 billion to help restructure banking systems in Mexico, Argentina and India.
- Since 1971 IFC has invested and made available some \$3.5 billion in the financial and capital markets sector, covering more than 560 separate transactions to clients in over 50 countries, in the process helping create some 551 successful financial institutions.

- And, under G10 leadership, the Bank, IMF and Basle Committee of Bank Supervisors, is working on a common set of prudential supervisory guidelines.

But concerned as all of us should be about financial market risk, overarching all this is a much larger risk the risk of not spreading broad development benefits more widely

- A very large group of countries have not yet been able to hook up to the driving dynamics of expanded capital, trade and information flows. Some others are so laggard that they face potential marginalization.
- Of the \$244 billion in private capital going to developing countries, 75% is going to just 12 countries. 140 of the 166 developing countries receive less than 5% of total capital flows. Over the last three years Sub Saharan Africa (excluding South Africa) received only about 1% of total private capital flows.

Contrast East Asia and Sub Saharan Africa

- East Asia today accounts for 29% of the world's pop, but only 6% of world GDP and 6% of its exports.
- On current trends, by 2020, only one generation away, the proportion of the world's population that is in East Asia will be about the same, but the region will account for 21% of world GDP, and 35% of world exports.
- China and Indonesia will be respectively the world's largest and seventh largest economies. Average per capita incomes in these 2 giant countries will be about \$9000 (ppp in today's prices) roughly equal to 1/3 the level in the US today.
- East Asia will represent an enormous market for the sophisticated, high-tech products and services exported by the West. It will also be the world's main source for labor intensive manufactured products.
- By contrast, SSA which today accounts for only 1% of world output and world exports, but nearly 10% of the world's population, will, on current trends, see its population rise to exceed 1 billion, but its share of world GDP and trade become even less significant.

Or take infrastructure which is absolutely central to development and where there is an enormous role for the private sector...

- Developing countries will need to invest \$200 billion a year for the next 10 years - -\$2 trillion by 2005 --- in basic infrastructure. In the 1990s capital market finance for infrastructure has grown enormously - increasing some eightfold to around US\$22 billion in 1995.

Yet when it comes to infrastructure financing, again the picture is very uneven

- Latin America, East and South Asia (and Europe and Central Asia recently) have all experienced fast growing private sector financing.
- In 1995, East Asia raised almost \$14 billion through international loans, bonds and equity issues; compared with \$370 million in the Middle East and North Africa, and \$396 million in Sub Saharan Africa).

And that unevenness is contributing to widening income disparities

- Low income countries make up 56% of the world's population but have less than 5% of the world's income.
- And inequalities between rich and poor countries are growing - between 1960 and 1990 the gap in the percapita income between the industrial and the developing worlds tripled - from \$5,700 to \$15,400. The share in global incomes of the poorest 20 percent of the world's population has fallen from 2.3% to 1.4%.

These kinds of inequalities must ultimately throw into question the sustainability of the economic and political reform process. They also threaten global stability

- 80 countries are worse off today than they were 15 years ago
- Last decade more than half of the world's low-income countries experienced conflict.
- Many of these conflicts spill across national borders - Rwanda, Burundi, Zaire.
- But even if conflict doesn't spill over militarily, its spills in other ways - Between 1985 and 1995 the number of refugees doubled. (now 30 million).
- Take Bosnia, a country of 4 million people of whom 2 million are displaced, 350,000 living in Germany, a major drain on that country.

And the quality of life for all our children

- Despite Rio, carbon emissions have grown by nearly 200 tons since 1990, reaching a record high of 6.3 billion tons of carbon in 1995 - a 3% increase in 5 years.
- 2 million deaths from tuberculosis every year; 856,000 from malaria; globally 23 million infected with the AIDS virus.

But the bottom line is that without foreign assistance many of these developing countries have little hope of ever escaping from marginalization and becoming the emerging markets of tomorrow

- Vital role of the Bank and IDA in creating an enabling environment for private investment.

- This means not just education, roads, communications and policy reform but capacity building, governance, legal reform, facilitating public-private partnerships.....and it's starting to pay off.
- In Africa there are clear signs that private capital flows are beginning to respond to the fact that countries are reforming their economies and creating a better climate for the private sector. In 1993, net private flows were still negative. Last year private capital flows reached 11.8 billion.
- And there have been some notable FDI success stories - Uganda where FDI rose by 38% in 1995 and an estimated 28% in 1996; Tanzania, where FDI rose by 200% in 1995 and an estimated 27% in 1996. Or take portfolio equity flows, where Cote d'Ivoire received \$30 million in 1996 up from \$3 million in 1995, and Kenya received \$15 in 1996 up from nothing the year before.

And the beauty of helping developing countries is that this isn't charity.....it makes perfect economic sense.

- By the year 2030, 3 billion people will have been added to the world's population, with 90% of the increase coming in today's developing countries, forming immense markets if economic and social stability prevails.
- Between 1990 and 1995, U.S. exports to developing countries surged 75%, twice as fast as exports to industrialized countries. Developing countries are the fastest growing US export market. Today they represent about 42% of total US exports.
- According to the U.S. Treasury, exports to markets where the World Bank or regional banks operate are responsible for creating or sustaining nearly 4 million U.S. jobs each year.
- Take New Jersey: Between 1990 and 1995, New Jersey's exports to developing countries rose 51% to \$3.9 billion, according to the US Treasury, accounting for some 78,000 jobs.

Moreover for all the talk of cheap foreign competition and downsizing

- In the last 5 year, US exports to developing countries have grown at 12% a year, 2% faster than imports from these countries, and over twice as fast as domestic demand in the United States.
- If you run an American business, you are more likely to have upsized to export to a developing country than you are to have downsized because of competition from these countries. And if you are an American consumer, you have unequivocally benefited from lower prices, both those of foreign products and those of American products faced with increased foreign competition.

In short: What are the risks and what are the opportunities?

- The opportunities are enormous.....
- The risks of overheating, volatility and banking collapse are serious and need to be managed.
- But the greatest risk of all is that 144 of the 166 developing countries will continue to receive less than 5% of total capital flows, and that we will fail to seize the opportunities offered by development because political leaders in the developed world won't stand up and begin to make the case for development.
- That case is simple: that our prosperity lies in their prosperity and that there is much more reason to fear the consequences of poverty, disease, and instability in the marginalized developing countries, than to worry about downsizing in the face of increased developing country competition.
- Just as it was once that quintessential emerging market - Colonial America, today it is the developing countries which represent the world's best long-term hope for increased prosperity, security and peace.

C. Anstey
4/28/97

The Emerging Markets and Private Equity

World Bank Group and Emerging Markets

- The nearly universal embracement of a market economy, the more liberalized global trade regime, and expansion of international capital flows have given the Emerging Economies their best prospects for almost a half a century.
- **Market economy approach.** A market economy approach has proven to be the best way to create macroeconomic growth, producing jobs, increasing exports, increasing income and achieving high rates of growth on a sustained basis by attracting foreign and domestic private investment. With more private flows readily available, and with more of the world now participating in the global market economy, private sector development has become a primary engine of economic growth and the paradigm within which the WBG can assist developing countries to achieve its ultimate mission of reducing poverty.
- Slow growing economies need to raise their savings and investment rates from the current 12-16 percent of GDP to at least 20-25 percent. Initially most of this change will have to come from better fiscal management, improved incentives for investment, and lower inflation rates. This means reducing government expenditures and increasing revenues by simplifying tax regimes, abolishing exemptions, reducing the discretionary authority of tax and customs administrators and improving collection capacity.
- An expanded role for the private sector will also have a major impact on the fiscal picture, most importantly creating the fiscal space necessary for macroeconomic stability and freeing up more resources for investment in people. Privatizing loss-making state enterprises and turning to private capital for infrastructure services (estimated requirement of about \$250 billion/year) frees up government resources for education, health programs, community service and other social programs. The vast sums of money that are now wasted subsidizing or bailing out money-losing public enterprises, or that are lost through special tax exemptions need to be put to good use as investments in people.
- Our estimates show that 25% of African budgets are needed to cover losses from state owned enterprises losses – which means that 2-3 time more of the scarce budgetary resources are spent on SE losses than for health and education.
- The **Bank Group promotes private sector development** in four ways:
 - **Helping Create an Enabling Environment:** Beyond emphasizing the adoption of sound macroeconomic policies, the Bank Group supports the creation of the “business environment” by helping its country clients create regulatory frameworks that reduce red tape and other barriers to competition,

strengthen legal and judicial systems, support entrepreneurial development, and promote sound foreign direct investment regimes.

- **Helping Strengthen Financial Sectors and Domestic Capital Markets:** The Bank Group supports fundamental financial market reform aimed at fostering competition, improving prudential regulation and supervision, and promoting sound banking systems, security markets, housing finance, and microenterprise finance.
 - **Funding Private Enterprises and Projects:** The Bank Group directly (and through financial intermediaries) is the single largest source of finance for private sector projects in developing countries. The Group funds private enterprises and projects by providing a full range of loans and equity finance and derivative products.
 - **Catalyzing Market Funds and Investment:** The Bank Group plays a catalytic role in mobilizing market funds by mitigating non-commercial risks through its various financial instruments, particularly its IFC loan syndications, IBRD guarantees, and MIGA political risk insurance. We are actively studying how our guarantee services can be expanded. The Group also facilitates private investment by offering country and market data, investment promotion services, and advisory services for corporate restructurings and privatization of state enterprises.
- There are many aspects of our private sector work, but overall, our objective is to help the private sector grow and flourish precisely because without such development our client countries cannot make progress in alleviating poverty. And as private investment to emerging economies continues to surge, and official assistance to the developing world continues to stagnate, our role becomes that of a catalyst to ensure that private capital flows reach these emerging economies.

Emerging Economies Prospects

Growth Prospects for Emerging Markets

- Emerging economies have created 50% of the growth in the world's GDP in the past five years – that accounts for 40% of the growth in world trade.
- The Bank expects that emerging economies will continue to grow at an average rate of 5-6% a year into the next decade, double that of the major industrial economies.
- Real GDP growth in the major emerging market economies is forecast to increase to 5.7 percent in 1997 from an estimated 4.7 percent in 1996. The growth rate is likely to

be more than double the average for the G-7 countries, and the highest since 1984. The differential in growth between the emerging markets and the G-7 is likely to widen to about 3.5 percent in 1997 from around 2.5 percent last year.

- The Emerging Economies' share of the World's GDP in 1996 was 20 percent, and at these differential growth rates is forecast to reach nearly 30 percent in the next decade.
- Stronger growth projected in emerging market economies in 1997 reflects an acceleration in output in Latin America and Eastern Europe. At the same time, growth rates in Asia, while moderating on average, remain significantly above those in all other regions.
- The improved outlook for Latin America in 1997 reflects positive growth in all countries. For the region as a whole, real GDP is forecast to rise 4.3 percent following growth of 3 percent in 1996. Argentina, Brazil and Mexico are all forecast to record growth rates of 4 percent or above. In Venezuela, activity is expected to rebound in 1997, led by a strong oil sector. In 1996, Venezuela's GDP is estimated to have shrunk more than 1 percent due to a sharp contraction in the non-oil economy.
- Due to ambitious programs of macroeconomic stabilization and structural reforms undertaken by Latin American countries in recent years, these countries enjoyed a two percent growth increase a year during the early 1990s, a 3 percent increase in 1996, and are projected to reach a 4.3 percent increase in real GDP in 1997. The changes in policy created high expectations for the region, and many observers question whether actual growth outcomes in several Latin American countries have measured up to such expectations. While economic growth *has* in fact been faster in the region during the nineties than during the previous decade, the growth recovery in the aggregate can be judged inadequate in comparison with growth in the East Asian Miracle countries, and with "desirable" growth rates in the region itself. Still, the response of economic growth to reforms in Latin America has not been disappointing, and we expect continued positive growth in the region.
- In Asia, growth slowed to an estimated 7.8 percent in 1996, reflecting the progressive tightening of monetary policy in many countries in the region from early 1995. Growth is forecast to remain below 8 percent in 1997. The slowdown in activity is most pronounced in South Korea and Thailand where GDP growth is forecast to fall to 5.5 percent in 1997. Growth in China, however, will maintain itself at about 10 percent, or just below. Importantly the concern on an overheated economy has resided.
- India's growth has continued to 7 percent in 1996 for the third year in a row, while inflation was continued to be moderate and the country's external position has continued to improve. There is concern, however, that this good performance may not be sustained absent stronger efforts to correct persistently large fiscal imbalances, dramatic shortages in infrastructure, and still considerable catching up to do in the social sectors – half of India's labor force continues to be illiterate. Accelerating

infrastructure and human resource development requires strong corrective action by India's 25 states – many of which have a population larger than most countries in the world.

- In Eastern Europe and the CIS countries, real GDP growth slowed to 0.5 percent in 1996 mainly due to sharp contractions in output in Bulgaria and Russia, but also reflecting weaker growth in other East European countries. This comes however, after nearly a decade of dramatic political and economic transition that saw output fall sharply in many of the former Soviet bloc countries. In 1997, a turnaround in Russia, where output is forecast to rise 2.5 percent, should push regional GDP growth up to about 3.6 percent. Growth in Turkey, however, is forecast to slow to 5.5 percent in 1997 from 7 percent in 1996.
- There is also a slightly improved outlook for Africa in 1997, with real GDP forecast to rise to 3.6 percent in 1997, up from 3.1 percent in 1996.

Capital Flows

- The prospects for the Emerging Economies are clearly linked to the world capital flows, and vice versa.
- Private Capital Flows to emerging economies have risen to nearly six times their level in 1990 – from just \$44 billion then to \$244 billion today. These private capital flows now dwarf official flows in terms of relative importance, accounting for more than 86 percent of net long-term flows to developing countries [\$285 billion].
- Developing countries are attracting an increasing share of world capital flows. All categories of private flows rose in 1996. Within the total of \$244 billion, foreign direct investment rose to \$109 billion, a fourfold increase since 1990. Portfolio investment (bonds and equities) contributed almost \$92 billion to the rise in net flows, with bond issuance estimated at \$46.1 billion and equity investment estimated at \$45.7 billion.
- **How have the individual components of private capital flows contributed to this growth?**
- Aid flows (Official grants/loans) have been relatively constant since 1990 in the \$40-50 billion range [1995 level \$53.0 billion, 1996 estimate only \$40.8 billion]. Given the budgetary pressures in donor countries, prospects are not bright for expansion.
- Foreign Direct Investment, at about \$109 billion, now accounts for slightly more than 40 percent of the total capital flows to developing countries. While FDI to emerging economies has grown from just 12 percent of GDP in 1990 to nearly 40 percent of GDP in 1995, we expect it will continue but not necessarily increase its share in total flows.
- Portfolio Flows, however, are poised for strong growth.

- Mutual Funds took the early lead in investing in the EMs. The Capital Group recently celebrated the 10th Anniversary of the Emerging Markets Investment Fund which they launched in partnership with IFC. They now admit we had not really persuaded them that taking on the management of this fund would be profitable – they took it on more as a quixotic venture with limited downside.
- In 1986 there were just 17 country funds and only 9 regional or global funds. In 1995, less than ten years later, that number had mushroomed to 467 country funds and 816 regional and global funds.
- Pension Funds. Total assets of pension funds at the global level are estimated to have increased from \$4.3 trillion in 1989 to \$7 trillion in 1994. At the same time, the share of non-domestic investment in their portfolios rose from around 7 percent in 1989 to 11 percent in 1994. Together, this has resulted in an increase in total international investments, including both emerging markets and other industrialized markets, from \$302 billion in 1989 to \$790 billion in 1994.
- It is being forecasted that for the next five years, US pension fund commitments to emerging markets will grow some 25% per year, as opposed to the developed market commitment growth of 15% . With total assets of over \$5 trillion, US pensions are seen as a potentially huge source of new money for emerging economies. They can provide the longer-term capital that would help reduce volatility and improve efficiency in the developing markets.
- Mutual and pension funds current holdings in emerging markets is currently at 1 ½ - 2 percent - their investment objective is to get four to five percent of their portfolio into emerging market issues.
- Equity flows to Emerging Economies represent 30 percent of total portfolio flows (in particular portfolio equity flows involving institutional investors). The flows are expected to continue to rise - and to outpace the growth of FDI. In 1996, developing countries raised \$14.5 billion in equity issues, a 34 percent increase over 1995. ADRs and GDRs accounted for half of all placements. These depository receipts are attractive because they offer developing country markets a greater pool of investors than local issues, an important consideration for large deals in smaller markets.

Aggregate net long-term resource flows to developing countries, 1990-1996* (billions of US dollars)		
Type of flow	1990	1996
Aggregate net resource flows	100.6	284.6
Office development finance	56.3	40.8
Grants	29.2	31.3
Loans	27.1	9.5
Total private flows	44.4	243.8
Debt flows	16.6	88.6
Commercial banks	3.0	34.2
Bonds	2.3	46.1
Others	11.3	8.3
Foreign direct investment	24.5	109.5
Portfolio equity flows	3.2	45.7

* Source: World Bank Debtor Reporting System

• **What is the Outlook for Equity Flows in 1997?**

- We expect equity flows to rise about 12 percent in 1997 to approximately \$116 billion with an increase in both direct equity investment and portfolio flows.
- In Latin America, net equity flows are forecast to rise to \$35 billion in 1997 from \$33 billion in 1996. Increased regional trade has encouraged foreign companies to invest directly in the region to take advantage of the growing market. Ongoing privatization programs should also boost equity flows in 1997, particularly in Brazil.
- Equity investment in Asia is forecast to remain strong in 1997 as well. Of the \$61 billion net equity flows projected for the year, about half are likely to go to China, primarily in the form of direct investment. Countries in Southeast Asia are attracting increasing amounts of direct equity, particularly from Japan, whose companies have been investing heavily offshore in recent years. Indonesia is generating higher foreign investment as well, due to ongoing deregulation and privatization. Portfolio flows to Asia rose to an estimated \$19 billion in 1996 after falling in the previous two years. A similar portfolio flow into Asia is forecast for 1997.
- In Eastern Europe and the CIS countries, net equity flows, which slowed to an estimated \$12 billion in 1996, are forecast to rise to \$16 billion in 1997, assuming increased privatization in Russia and Turkey. Meanwhile, the strong performance of

regional stock markets, together with increased foreign interest, should encourage a further increase in portfolio flows.

- In Africa, net equity flows are expected to rise to almost \$4 billion in 1997, up from \$2.5 billion in 1996. The Bank Group has an important role to play in broadening the destination of these flows to reach more countries, particularly those in Sub-Saharan Africa, which received only 5% -- \$12.1 billion -- of the net private capital flows to developing countries in 1996.

Insights on Capital Flows

- A number of trends have provoked the increase in flows to emerging economies.
- The number one trend is that of market globalization. The world's financial markets are rapidly integrating into a single global marketplace, and developing countries are swiftly being drawn into this process. The responsiveness of private capital to this trend of globalization has recently gained significant momentum as a result of financial deregulation and major advances in technology and financial instruments. The quick pace at which financial technology is being disseminated globally is stimulating rapid changes in the markets.
- As part of this process of increasing global financial integration, gross private capital flows can be expected to rise substantially, with capital flowing not only from industrial to developing countries, but also, increasingly, among developing countries themselves and from developing to industrial countries.
- How countries respond to the initial surge of capital inflows, which is often associated with the opening phase of financial integration, will largely determine their success in dealing not only with overheating pressures but also with potential vulnerability.
- There are large potential costs if this global financial integration is not carefully managed. First, although international investors are becoming more discerning, market discipline tends to be much more stringent when investor confidence is lost. Second, and more important, many developing countries lack the preconditions needed to ensure the sound use of private capital and manage risks of large reversals.
- The challenge for developing countries, therefore, is how to take advantage of the growing investor interest in these markets and so to enter a virtuous cycle of productive financial integration rather than a vicious cycle of boom and bust.
- There is broad consensus that the most important prerequisites for this productive financial integration are a sound macroeconomic policy framework, in particular
 - a strong fiscal position,

- transparency in current account and external debt management;
 - the absence of large domestic price distortions,
 - a sound domestic banking system with an adequate supervisory and regulatory framework, and
 - a well-functioning market infrastructure and regulatory framework for capital markets.
- Which takes us to the importance of domestic capital market development in the Emerging Economies.

Capital Markets Development (as an element of the WBG's financial sector operations)
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- Although the World Bank did not concentrate on financial sector development for much of its history, activity has picked up sharply. Most important is that the nature of the Bank's work in the financial sector has shifted from primarily financial intermediary loans - which fared badly because of the weak public development banking systems - to more systemic operations. Work is currently ongoing in some 45 countries, through adjustment loans and advisory work as well as providing resources to financial intermediaries for lending to small and medium enterprises, but through a mix of public and private intermediaries.
- Between 1977 and 1996 about 15 percent of Bank lending, or about \$50 billion, supported almost 600 financial sector operations.
- In FY96, the Bank provided \$3.7 billion to support 20 new loans in its overall financial sector operations:
 - \$1.9 billion for 13 intermediary loans;
 - \$1.4 billion for 4 adjustment loans; and
 - \$.05 billion for 3 technical assistance loans.
- In most Emerging Economies, the banking system plays the dominant role in the financial sector, and the health of this system largely determines whether a country will be able to exploit the benefits of financial integration and avoid its pitfalls. Addressing the underlying weaknesses of the banking system, and the entire financial sector more generally, becomes more urgent in a globally integrated environment.
- A special feature over the past two years of Bank financial operations was the commitment of nearly \$3 billion to help restructure banking systems in Mexico, Argentina and India.
- The Bank Group is placing increasing emphasis on capital market development.

- Securities markets are an important element of establishing stable capital markets.
- Both the Bank and IFC are active in building various parts of the framework for securities markets. IFC's strength is its knowledge of the market, and the Bank's is its policy perspective. The Bank gets involved as part of comprehensive programs, such as legal, tax or accounting reforms. The Bank's sector adjustment operations also have components that address the framework for securities markets. IFC provides advice on legal and regulatory change to introduce new financial services – like local mutual funds, or instruments – such as securitization.
- The Bank's diversification in the financial sector into capital market development includes work in contractual savings. It has undertaken operations in pension system reform, most recently in Mexico where \$600 million was approved.
- IFC's Capital Markets work was launched in 1971 with a special focus on building securities markets by giving advice and technical assistance to government and helping set up specialized private sector financial institutions through loan and equity financing.
- IFC has pursued its capital market objectives by:
 - providing technical assistance to help create laws and establish regulatory agencies;
 - creating new institutions. IFC has worked with foreign and local sponsors to create new institutions, often the first of their kind in a country;
 - supporting existing financial institutions. IFC has helped domestic financial institutions expand their access to local and foreign financing sources (through provision of credit and agency lines, commercial paper programs, bond guarantees, etc.) and to strengthen their balance sheets (e.g., through swaps, the second tier capital and securitization of assets); and
 - encouraging financial institutions to reach under-served business segments – especially small- and medium-sized enterprises. IFC has used credit lines and promoted small- and medium-sized enterprise-focused institutions to improve the access of new, small- and medium-sized firms to financing.
- Since 1971, IFC has invested and made available through financial intermediaries some \$3.5 billion in the financial and capital markets sector, covering more than 560 separate transactions to clients in over 50 countries, in the process helping create some 551 successful financial institutions. In addition, it has provided technical assistance through nearly 800 projects in over 90 countries. The scale of IFC's capital markets operations has increased dramatically since the beginning of the 1990s, during which time capital markets have come to the forefront of the development agenda worldwide.

- IFC has an important role in helping its member countries develop dynamic domestic capital markets. By mobilizing significant amounts of resources, domestic institutional investors can serve as a counterweight to foreign investors and thereby assuage fears of excessive foreign presence; they also reduce the vulnerability of domestic capital markets to foreign investor herding, and their presence may reassure foreign investors about the nation's respect for corporate governance and property rights. IFC has helped supplement domestic resources by mobilizing external savings flows to emerging markets, and focused on developing domestic financial institutions and capital markets. This approach to "deepening" and "broadening" domestic markets has been critical to IFC's strategy of promoting growth.

Perspectives on Private Equity

- One cannot speak about private equity activities in the Emerging Economies without reviewing IFC's experience – as it represents over a 40 year period, the longest and most diversified track record of any significant institutional investor.
- IFC's private equity activities can be divided into two categories:
 - IFC direct equity investment, and
 - Equity funds

IFC Direct Equity Investment

- The capacity to make equity investments is a hallmark of IFC as a development institution. By making successful investments, even in difficult environments, IFC has set a powerful example which has stimulated the flow of private capital into productive investment, thus playing a true catalytic role. IFC's catalytic effect is enhanced by being able to show a good track record with its own investments.
- IFC has been making equity investments since 1962, when it was granted a formal mandate to do so. To date, more than \$3.4 billion in equity has been invested in 966 different companies, in 120 countries. IFC's current equity portfolio is valued at \$1.7 billion, invested in some 533 companies. Inevitably, not all these investments have been successful. But in all regions of the developing world, often in difficult environments and troubled times, the Corporation's equity investment activities have played a part in the progress that the private sector has achieved.
- Since FY62, when IFC's first equity investments were made, the amounts of equity invested each year show a strong and continued growth. However, the share of equity in total IFC financing was much higher in the first nine years, and while equity investments continued to grow, the volume of loans grew much faster starting around FY70.

- In the late sixties - early seventies, IFC management began to restrain new equity investment because of its limited capacity to tie up capital for long periods. Increased lending became possible with World Bank loans to IFC. However, operations involving only loans had to have a special justification. There is evidence that this requirement led to the sprinkling of small equity investments to avoid this procedure. In addition, there are suggestions that IFC staff added in equity investments to soften the financial costs to the borrowers of the market based lending rates.
- Starting in the late 1970s and becoming widespread in the 1980s, austerity and recessions in many developing countries reduced the opportunities for sound equity investments. The large devaluations accompanying these difficult conditions increased the risks for IFC in using hard currency to make equity investments, which earns returns in local currency. IFC's response was to decrease total equity commitments.
- However, beginning in the late 1980s and continuing through today, IFC has been giving more attention to equity finance. The share of equity has more than doubled with a more proactive equity investment strategy as a result of the strong contribution to net income.

	<u>FY82</u>	<u>FY91</u>	<u>FY96</u>
IFC Net Investment (Dollar Amounts in US\$millions)	\$421	\$1,529	\$3,214
Loan	\$390 (93%)	\$1,106 (72%)	\$2,445 (76%)
Equity/Quasi	\$32 (8%)	\$313 (21%)	\$621 (19%)
Equity	\$28 (>7%)	\$222 (16%)	\$310 (10%)
Other	-	\$109 (7%)	\$148 (5%)

- When the relative share of equity in IFC's overall financial operations reached a low point in 1982, when its equity activity of \$28.4 million accounted for less than 7% of all IFC activity. This was the outcome of several factors – the macroeconomic problems certainly made IFC more risk adverse, and in many cases, rightly so. But this was also due to prevailing financial policies and the inability to measure costs and returns played key roles.
- The failure within IFC to see the relative risk and reward pictures for lending versus equity could be a good subject for a business school case.

- On policy grounds, equity investments were deemed to be more risky, and an automatic up front 15 percent provision was made on every dollar invested in equity, versus 2 percent for new lending exposures. Actual profitability analysis had not been sufficiently developed to overcome the perception that the higher risk and labor intensive equity investments were not as profitable as loans.
- According to a recent comprehensive profit contribution analysis, lending operations were costing IFC -40 basis points from FY90-93, while the equity portfolio was making a highly positive contribution. Indeed when IFC took on the Herculean task of securing a AAA rating for its bond offering, one of the arguments put forward was that the equity portfolio provided an income upside that other MDBs did not enjoy. This was critical since unlike the MDBs, IFC's lending was not guaranteed by host governments.
- The results of the product line profitability analysis led to a concerted effort to bring IFC's lending to at least a break even operation which it did by 1996 (FY95 net income of loan portfolio -0.3% -- FY96 net income of loan portfolio 1.5%). However, the equity contribution is currently providing approximately three times more to IFC's profitability than the much larger volume of lending.
- It is projected that in FY97, net income from loans will be about \$87 million, equivalent to a return on disbursed portfolio of about 146 bp. Net income from equities is forecast at around \$265 million, equivalent to a return on disbursed portfolio of about 11% and a return on capital employed of 13.8 %.
- Of course it should be recalled that values in IFC's equity investment portfolio received a tremendous boost with the coming of the Emerging Markets movement – opening up of domestic securities markets to foreign portfolio investors which in turn stimulated opening of the domestic company shareholdings. This produced a real boom for IFC which had much earlier made direct investments in many closed companies. Exits became much easier and more profitable than had ever been imagined.
- To analyze the performance of IFC's equity investments, the main quantitative measures available are the financial results of those investments.
- The estimated Internal Rate of Return (IRR) on IFC's investments, evaluated as of the January 31, 1997, is 12.77 percent.
- The number of equities with net write-offs as of February 28, 1997 was 172 companies (both partial and full write-offs). The number of companies with write-offs as a percentage of total equities was 19.5%. However, in terms of dollar volume, net write-offs as a percentage of total cumulative equity disbursements was only 6.3%.

Figures for Estimated Nominal IRRs

<u>% of IRRs</u>	<u># of companies</u>	<u>% of companies with equity investments</u>	<u>dollar volume (the cumulative disbursements of these equities as a percentage of total cumulative equity disbursements)</u>
0-10%	406	46%	45.15%
10-20%	97	11%	12.20%
< 20%	123	14%	20.13%

- While overall returns for Eastern Europe are fairly low at 8.18 percent, for Asia returns are at 14.87 percent, and for Latin America, returns are at 15.89 percent. Not surprisingly, it is Africa, with overall returns at 3.18 percent, that brings down the total IRR. This reflects the unfortunate persistence of very depressed economic conditions, and perhaps somewhat of a mismatch between the type of investment that is likely to be most useful and most profitable and the type that IFC is most accustomed and positioned to do.
- The returns by sector show that for oil, gas and mining (22.32%), chemicals and petrochemicals (13.71%), for general manufacturing (12.05%), financial services (11.9%), infrastructure (10.69%), and food and agribusiness (10.63%) returns have been good. However, for textiles (8.73%), industrial and consumer services (-16.72%), and tourism (3.01%), the returns have been fairly low, even negative in the case of industrial and consumer services.

IFC Equity Funds

- In addition to its direct equity investments, IFC began about ten years ago to contribute to the development of capital markets through private equity funds. Private equity funds were seen as a very cost effective way for IFC to encourage growth, and by sponsoring such funds IFC sought a role in catalyzing resources that heretofore had not gone to emerging economies.
- However, this form of investing was not immediately embraced. For an institution with a long tradition of investing directly in the equity of companies through part of a funding package for project finance structures, there was a strong reluctance to entrust the investment fund management to third parties and an aversion to investing in publicly traded shares.

- IFC made its first investment in a private equity fund in 1978 in Spain. Today IFC has almost \$600 million invested around the world in 83 funds. The total capitalization of these funds are \$4.365 billion (total worth of all funds). The lion's share of the funds are in Asia and Latin America.
- IFC's existence as a development institution adds the dimension of developmental impact to its private equity effort, while in no way limiting its focus on profit maximization. The Corporation's ability to be both an investor and a lender gives it the flexibility to function effectively as a catalyst, an "honest broker" and as a fully contributing partner.
- IFC's experience in emerging markets has at times been very painful. Valuable perspective has been gained and key lessons learned from the early investments in emerging economies:
 - First, timing is very important. The proper economic environment is key to the success of private equity funds, particularly country specific. Where hyperinflation exists or markets are still regulated or closed, equity funds will meet with limited success.
 - The structure of the management company is also critical. In one case the management company, although separately incorporated, remained a division of a commercial bank.
 - The management of the fund also has an immeasurable impact. However, in some cases, IFC, and its partners, has relied on the wrong skill base. In one case in particular, the key manager was a commercial banker, masquerading as a "venture capitalist".
 - And last, performance-based incentives can have enormous impact. Management skills are in shorter supply than investable funds or business opportunities. Managers must be incentivized to personally participate in long-term successful performance of the funds.
- Some of the variables that exacerbated the IFC supported funds were
 - Small fund sizes – an average of just \$11 million. Fund income couldn't come close to supporting management expenses.
 - The size and number of Fund deals were very small, in part because of a small amount of committed capital.
 - Fund investors were often not institutional investors. In cases where investors were largely domestic industrial groups, the investments were influenced by

these companies own strategic aims and financially attractive opportunities were overlooked. They could not be relied upon for subsequent rounds of financing.

- In some cases economic analysis, in particular the effect of tariffs and other protections, on the long-term viability of some sectors was faulty. With widespread macroeconomic policy restructuring in the Emerging Economies and general trade liberalization, investee companies could not survive without protection.
- And most importantly, IFC failed to address the liquidity issue - very few investments were made with serious consideration given to exit possibilities, let alone the development of an up-front exit strategy. In one case, the fund's last remaining investment consisted of a deer farm for venison, with no-added value activities such as slaughtering or processing. While I never heard how we got rid of the investment, I understand half of the nearly 10,000 deer had either escaped or died by the time of the sale. This "self-liquidation" strategy is certainly not one I would advocate.
- The issue of liquidity is one of great importance in capital market development. In fact, recent studies point to liquidity of the market as being more closely linked with faster economic growth than the market capitalization to GDP ratio, even after accounting for non-financial factors such as inflation, initial income levels, political stability, investment in education, the black market exchange premium, and the efficiency of the legal system.
- If equity flows are to continue to rise and outpace the growth of FDI, as they are in fact predicted to do, it is important that the Bank Group learns from its experience and ensure that its own private equity effort ultimately supports the development of robust markets.

Richard Frank
Extracts from a speech to
the ING Barings Executives Global Partners Meeting
April 10, 1977

Background brief

Private Capital Flows to Developing Countries

Growth of flows: The 1990s has seen an explosion of private capital flows to developing countries. It has gone from around \$32 billion in 1989 to an estimated \$230 billion in 1996.

Composition of flows: Foreign direct investment is the largest component (estimated \$93 billion for 1996). But a notable feature of this upsurge has been the growth of portfolio flows, both bonds and equities. Starting from almost nothing in 1989, portfolio flows are estimated to reach over \$90 billion in 1996. These flows have continued to increase despite higher international interest rates and the Mexican peso crisis.

Growth of stock markets: Today over 60 developing countries have stock markets, compared with half that number in 1985. Their capitalization has increased more than ten-fold over the past decade, from \$171 billion in 1985 to \$1.9 trillion in 1995. Liquidity has increased even faster: turnover rose from 26% to 85% of emerging market capitalization between 1985 and 1994. And the number of domestic companies listed on emerging markets more than doubled from around 9,000 in 1985 to nearly 19,500 in 1995.

Behind the growth. Economic growth has been on the upswing in developing countries. Their GDP is growing at 5-6 percent a year [twice the OECD rate] and we expect this growth to continue into the next century. Prospects for higher returns and opportunities for risk diversification have led to growing investment in emerging markets by institutional investors. In 1986 there were 17 emerging market country funds and 9 regional or global funds. By 1995 there were nearly 500 country funds and over 800 regional and global funds, which are allocating increasing proportions of their portfolios to emerging markets. Pension funds have followed suit.

Strong fundamentals attract investment: Countries with the strongest economic fundamentals [e.g., high investment/GDP ration, low inflation, and low real exchange rate variability] have received the largest flows as a proportion of domestic GDP. Portfolio flows remain sensitive to movements in both global and domestic interest rates, but the fundamentals are at work here too [the country credit rating, secondary bond prices, price-earnings ratios in domestic stock markets, etc.]

The benefits of this growth: This growth in investment – and in the capacity for local investment – helps developing countries. It fuels the growth of business enterprises that are bringing new prosperity, jobs and a better life around the world. It helps us at home too. U.S. exports to developing countries have more than doubled from \$91 billion in 1987 to more than \$191 billion in 1995.

Problem -- the concentration of investment: The disturbing trend is that over the period 1990-95, only a dozen countries accounted for more than 90 percent of net private flows [although countries such as Hungary, India, Poland, the Philippines and Vietnam are attracting more private capital since 1993]. The entire continent of Africa received less than \$5 billion in private capital flows in 1995, less than 3 percent of the total for developing areas.

Problem – cautious institutional investors: Despite impressive increases, the share of emerging markets in the portfolios of institutional investors remains small. Even in the US, where institutional investors have increased their exposure to emerging markets more rapidly, mutual funds and pension funds are estimated to hold an average of only 2 percent of their portfolios in emerging markets. For most other industrial countries these shares are much lower.

Variation in volatility of flows between countries: Volatility of portfolio investment has been a major concern since the Mexico Peso Crisis, although it has shown an impressive comeback since the first half of 1995. Overall volatility of private capital flows has come down in the 1990s. This suggests that markets have entered a more mature phase. Governments have shown an awareness and ability to respond quickly and aggressively to changes in market conditions. But there is also significant variation in volatility [Asia being less subject to volatility than other areas]. And markets have become more discriminating between countries on the basis of their underlying fundamentals.

The volatility of capital flows and potential vulnerability to reversals remain a concern at the level of individual countries. Venezuela and Turkey were the first to experience major capital flow reversals in the 1990s [Venezuela had a reversal of \$5.4 billion, or 9 percent of GDP from 1992-94; Turkey lost \$19 billion, or 11 percent of GNP, 1993-94]. Mexico's reversal was notable not only for being the largest in terms of magnitude [\$20.4 billion], but also for triggering large reversals in several other countries, most notably Argentina and Brazil.

The sources of vulnerability:

1. Emerging markets remain more susceptible to potential **investor herding**.
2. Many countries are trying to maintain macroeconomic stability **without strong fiscal underpinnings**. Interest rates in these countries tend to be high, attracting short-term flows, but sometimes without the necessary long-term fundamentals.

3. The **banking systems** in many recipient countries are quite fragile, and the surges in flows can greatly exacerbate these vulnerabilities. In many cases, banking systems have only recently been deregulated, the incentive framework is distorted toward excessive risk taking, banks are poorly capitalized, and prudential regulation and supervision capabilities have not yet been established.

Policy lessons from cross-country experience:

1. **Fiscal policy** needs to be even more cautious and responsive in the face of large capital inflows. This will both alleviate pressures of overheating and reduce vulnerability to large reversals.
2. There is strong merit in **curbing lending booms** associated with capital inflows while addressing the underlying weaknesses of the banking systems.
3. Development of **well-functioning capital markets** will both reduce risks of potential instability and attract a growing pool of portfolio investment.

The Response of the World Bank Group

The World Bank Group has been working hard to help our client countries (where 4.5 billion people live) meet the challenges of attracting investment and avoiding volatility. Some of you may be more familiar with the Bank than others, so perhaps I should take a minute to give you an overview of what we look like:

The IBRD and IDA. First, there is the *World Bank* itself. This is the original Bank, which was created to make loans to sovereign governments for purposes of reconstruction. Over the years it has evolved from an institution that lent mostly for infrastructure into one that lends around \$22 billion a year in all areas of development, including agriculture, the environment, health and education. The Bank has a concessional lending arm, the *International Development Association* (IDA), funded by taxpayer dollars, which lends to the poorest of poor countries [e.g., most African countries fall under IDA – for about half its total lending of around \$6 billion].

IFC. Second, there is the *International Finance Corporation* (IFC), the part of the World Bank Group that works directly with the private sector. In partnership with corporations and financial institutions, IFC works in countries where there are great investment opportunities, but where the private sector is generally unwilling to go, building a base for the local private sector to take off. Since its founding in 1956, it has provided financing to nearly 2,000 companies in 125 countries. Last year alone, IFC mobilized more than \$8 billion in support of projects worldwide with investments in infrastructure, emerging stock markets, improved regulatory environments and much more. And IFC is growing.

MIGA. Third, there is the *Multilateral Investment Guarantee Agency* (MIGA), which provides private investors going into developing countries with guarantees against

political and other non-commercial risk. Its guarantees have catalyzed foreign direct investments now totaling an estimated \$15 billion, and its on-line marketing and information service — the IPAnet — offers data and analysis on the business climate in more than 90 countries.

The changing Bank Group. As a Group, we are changing. We are increasing the level of service to our clients; creating new products; and acting as a connector and broker between governments, the private sector, and civil society. We are becoming what I have called the “Knowledge Bank,” by which I mean we will be able to use the information technology available now to make our vast store of knowledge on almost any topic in development and make it universally available. We are also working together more closely as a group. This is particularly true of our efforts in the private sector. We have created the *Private Sector Development Group*, which unifies the different areas of the Bank working on private sector issues.

What have we been doing?

Legal and policy framework. We are working throughout our client countries to help them build the legal and policy framework that will make them attractive to investors and allow real competition. [you may want to mention capacity building and anti-corruption measures in connection with this].

- **Russia** is a particularly interesting example because they have had to start from scratch with building a regulatory structure for private investment and transactions. The Bank Group, and particularly IFC, have been helping Russia design a capital market development strategy flexible enough to meet its constantly shifting conditions. Given how massive its privatization program has come, we have had to act quickly to help new capital markets handle the pressure. IFC has responded by sending experienced senior staff to advise the Russian Federal Commission for Securities Markets (a new body with ministerial status that is principal regulator of capital markets); and it has helped several regions with voucher privatization programs.
- **India** is another good example. Beginning in 1991, with our advice and support India implemented economic reforms such as investment deregulation, trade liberalization, financial reforms and tax reforms that have transformed the environment for private investment. New rules for foreign portfolio investment have made it a lot easier to participate in stock markets. As a result Foreign direct investment went from \$165 million in 1990 to more than \$600 million in 1994. Portfolio investment went from next to nothing in 1990 to more than \$4 billion in 1994.
- And we are expanding our work to improve the investment environment into new, tougher environments. At our Annual Meetings this year, IFC announced a new

initiative that will extend its reach to 24 nations where it has never worked before — such as several Central African nations.

Private sector assessments. In many countries, the structure of the private sector and the constraints to its development are not even known. Since 1992 we've been carrying out private sector assessments, and these are forming the basis of dialogue with government on joint work in policy and institutional reform. We've done over 30 of these in countries as diverse as Ghana, Indonesia, India, Poland and Egypt; and we have a half dozen more being done this year.

Building financial institutions. Financial sector development is at the core of building a business-friendly environment, and we are lending in support of both policy reforms and building the technical capacity of financial institutions to handle systemic shocks like the Mexico and Argentina crises. We are working to build up our own specialized expertise in areas like privatization of state-run banks, banking supervision, central banking, liquidity management and dealing with bad assets.

- For example, we are involved in building financial systems throughout **the former Soviet Union and Eastern Europe**. In **Russia** our support for financial institution development comes in the form of one of the largest technical assistance loans the Bank has ever made -- \$200 million -- to build the capacity of 25 core private commercial banks which will have to operate at International Banking Standard. In Poland a technical assistance project has successfully twinned Polish and international banks. In Hungary, the Bank and IFC began work to build bond and equity markets as far back as 1985, and we are now helping Hungary with a loan to build its banking supervision capacity. We are also providing significant technical assistance and advice to Latvia and Lithuania in dealing with their present financial sector problems.
- In **India**, IFC invested in the first country-wide stock brokerage, which allowed arbitrage among its 16 or so stock exchanges. IFC also helped pave the way for private sector mutual funds in India.
- I should add that at our Annual Meetings a couple of months ago, the Managing Director of the IMF, Michel Camdessus, and I announced that the Bank and the Fund would be launching a joint initiative to work together in finding ways of improving financial systems in the developing countries.

Building portfolio investment funds. In 1984, our International Finance Corporation (IFC) helped catalyze the emerging markets portfolio industry when it launched the Korea Fund [a \$60 million issue, publicly offered on the NYSE, with management by Scudder, Stevens & Clark; and underwriting syndicate led by First Boston Group, the IFC and Shearson Lehman]. Two years later the IFC helped launch the Emerging Markets Growth Fund, the first global fund targeted at emerging markets [starting with

\$50 million, by 1994 the EMGF had net assets of \$5.5 billion]. These early successes kindled the interest of investors worldwide. Since 1986, the IFC has underwritten or invested in over 30 other portfolio investment funds. For each dollar that IFC has invested in funds, other investors have provided an average of \$6.80 [i.e., IFC's own commitments of \$806 million have been associated with \$6.3 billion at initial fund capitalization].

Providing advice to our clients. Our **Foreign Investment Advisory Service (FIAS)** is a joint venture of the Bank and the IFC which for 11 years has advised governments [in about 100 countries] on investment laws and regulations, taxation, and ways to attract investors; it also helps governments establish investment promotion agencies. In China, for example, FIAS helped the government overcome its unwillingness to convert local currency earnings to foreign exchange by advising it in creating what became a national, computer-linked free market for forex. FIAS' most recent project in China has aimed to accelerate private infrastructure investments by eliminating policy and regulatory bottlenecks.

Increasing information. Finally, we are producing the information that investors need to enter new markets with adequate levels of comfort. The **Emerging Markets Data Base**, produced by IFC, has gained international recognition as the world's premier source of reliable and comprehensive information on stock markets in developing countries [it covers 44 of them]. It is the basis for The IFC Investable Indexes (IFCI), which have become the principal benchmark for emerging markets used by institutional investors. Four years ago, virtually no emerging markets investments were made on a "passive" indexed basis. Now nearly \$10 billion is managed by index. Roughly three-quarters of this is based on IFC indexes.

Amar Bhattacharya
IFC

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CONTACT:

Mark Constantine
Phone: (1-202) 473-9331
Fax: (1-202) 676-0365
E-mail: MConstantine@Worldbank.org
Amy Conran
Phone: (1-202) 473-9119
Fax: (1-202) 676-0365
E-mail: AConran@Worldbank.org

IFC ANNOUNCES INITIATIVE TO REACH NEW MARKETS
—EFFORT AIMED AT BOOSTING PRIVATE SECTOR IN CHALLENGING ECONOMIES—

WASHINGTON, D.C., Oct. 1— The International Finance Corporation (IFC) has formally announced the "Extending IFC's Reach Initiative," a program to expand the geographic range of IFC's activities to smaller and poorer countries and countries undergoing particularly difficult transitions to market economies. Sixteen countries, or clusters of neighboring countries, have been selected for the program. A list of the countries follows this release.

The Extending IFC's Reach Initiative was established to promote private sector development in countries where IFC's activity has been severely constrained as a result of challenging country conditions and obstacles to private sector activity.

"IFC's traditional program of investment and advisory activities is strongest in countries where workable solutions have been developed to overcome impediments to private investment, but we are looking for ways to increase IFC's impact in the poorest countries and most difficult investment environments," said Jannik Lindback, IFC's Executive Vice President. "Through this Initiative, we will take on additional risks and expenses to make a real difference on the ground."

The Initiative will be implemented as a three-year pilot program and will have two basic elements. First, in each of the selected countries, IFC will place investment staff in the field to provide an extended IFC presence in the country. Field staff will develop an understanding of the country's needs in the private sector. They will cultivate relationships with local entrepreneurs, the financial and legal communities, government authorities and representatives of other multilateral and bilateral development institutions. They will work closely with clients to develop viable projects.

Second, IFC has created a US\$40 million Small Enterprise Fund to support smaller-scale investments in the pilot program countries. The Extending IFC's Reach Initiative will seek opportunities for the full range of IFC activities. However, IFC expects that in many instances the only feasible investments may be small because of the limited scope of private enterprise in these countries. The Small Enterprise Fund will be used to invest in projects with total costs between US\$250,000 to US\$5 million. IFC's own investments are expected to range from US\$100,000 to US\$2.5 million, covering approximately 40 percent of each project's total cost. The Fund will primarily provide debt financing but will also have the flexibility to make equity and quasi-equity investments and to provide local currency guarantees.

The countries covered under the Initiative are geographically diverse. While significant obstacles to private sector development remain in these countries, they are all taking positive steps to establish a more open, market-based economy. For example, in Mongolia, one of the most impoverished countries in Asia with limited infrastructure and lack of a modern financial sector, IFC will seek opportunities for investment in tourism, textile and leather projects. The territories of West Bank and Gaza also pose significant hurdles for private sector investment. IFC will seek to promote micro-lending facilities and assist small business entrepreneurs in structuring bankable projects. In Bosnia-Herzegovina, whose economic asset base of companies, factories, banks, and infrastructure has been depleted by war, IFC expects to establish a small business lending facility and a venture capital fund to provide equity capital to small and medium sized businesses. To respond to the needs of Senegal and the countries of Western Africa, one of the poorest regions of the world, IFC will open an office in Dakar to provide support for business ventures in sectors such as agribusiness and tourism.

"We see implementation of the Initiative as an extremely valuable learning experience. It will tell us much more about how to operate successfully in the most challenging environments and to develop tailored investment programs for these markets," added Mr. Lindbaek.

IFC, a member of the World Bank Group, is the largest multilateral source of equity and loan financing for private sector projects in developing countries.

COUNTRIES TARGETED FOR EXTENDING IFC'S REACH INITIATIVE

Albania

Azerbaijan

Bosnia-Herzegovina

Cambodia and Lao People's Democratic Republic

Central Africa:

(Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon)

El Salvador

Ethiopia and Eritrea

FYR Macedonia

Guyana and Eastern Caribbean:

(Antigua and Barbuda, Dominica, Grenada, St. Kitts & Nevis, and St. Lucia)

Kazakhstan

Mongolia

Mozambique

Senegal and Western Africa

(Mauritania, Mali, The Gambia, Guinea, Cape Verde, Guinea-Bissau)

Slovak Republic

Uzbekistan

West Bank and Gaza

(30)

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WBG ARCHIVES

**FINANCIAL STABILITY
IN EMERGING MARKET ECONOMIES**

**A strategy for the formulation, adoption and implementation
of sound principles and practices to strengthen financial systems**

April 1997

**Report of the working party on financial stability
in emerging market economies**

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EXECUTIVE SUMMARY

In response to an initiative at the Lyon summit in June, 1996, representatives of the countries in the Group of Ten and of emerging market economies have jointly sought to develop a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing substantial changes in their financial systems. This enterprise has been prompted by the recognition that banking and financial crises can have serious repercussions for these economies in terms of heightened macroeconomic instability, reduced economic growth and a less efficient allocation of savings and investment.

Representatives of Argentina, France, Germany, Hong Kong, Indonesia, Japan, Korea, Mexico, the Netherlands, Poland, Singapore, Sweden, Thailand, the United Kingdom and the United States participated in the work, which was carried out under the chairmanship of Mario Draghi, Chairman of the Deputies of the Group of Ten. In the course of the work, representatives of these economies consulted with officials from other countries in order to take account of their views on the matters being considered. Representatives of the Basle Committee on Banking Supervision, the International Accounting Standards Committee (IASC) and the International Organisation of Securities Commissions (IOSCO) and staff members of the Bank for International Settlements (BIS), the European Commission, International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD) and the International Bank for Reconstruction and Development (World Bank) attended the meetings and provided crucial input. The working party also consulted with other international groupings, received contributions from a number of regional development banks and had the benefit of market participants' views.

The aim of the work is to develop a concerted international strategy to promote the establishment, adoption and implementation of sound principles and practices needed for financial stability. The strategy has the following major components:

- Development of an international consensus on the key elements of a sound financial and regulatory system by representatives of the G-10 and emerging market economies;
- Formulation of norms, principles and practices by international groupings of national authorities with relevant expertise and experience such as the Basle Committee, the International Association of Insurance Supervisors (IAIS) and IOSCO;
- Use of market discipline and market access channels to provide incentives for the adoption of sound supervisory systems, better corporate governance and other key elements of a robust financial system;
- Promotion by multilateral institutions such as the IMF, the World Bank and the regional development banks of the adoption and implementation of sound principles and practices.

In developing this strategy the working party has been guided by three fundamental premises:

- Ultimate responsibility for policies undertaken to strengthen financial systems must lie with the national authorities who have a strong interest in developing sound arrangements for their financial systems;
- In an increasingly integrated global economy, financial sector stability is most likely to be achieved when international prudential standards are met and when markets operate competitively, professionally and transparently, according to sound principles and practices that generate the relevant information and appropriate incentives.
- Sound macroeconomic and structural policies are essential for financial system stability to prevent or at least limit the emergence of serious financial imbalances, misleading price signals and distortions in incentives.

Financial stability requires sufficient political and social consensus supporting the measures needed to establish and maintain that stability. A financial system that is robust is less susceptible to the risk that a financial crisis will erupt in the wake of real economic disturbances and more resilient in the face of crises that do occur. Although reforms are in many cases urgent, the time required for their implementation will differ considerably depending on the nature of the reform and the need for appropriate sequencing. The international community can be of assistance by developing in a consultative manner a corpus of sound principles and practices bearing on financial system robustness and supporting their adoption and implementation.

Sources of financial instability

Past experience demonstrates that financial instability in emerging market economies can be attributed to a wide range of microeconomic and institutional failings. However, it is almost invariably in an unstable macroeconomic environment, in the wake of major structural transformations, or as a result of important distortions in the real economy that these failings give way to systemic crises. Emerging market economies have been more prone to boom-bust cycles and to sudden corrections in asset prices, in part because they have tended to be less diversified and less able to absorb shocks than more mature industrial countries. Macroeconomic instability in emerging market economies has also reflected weaknesses in macroeconomic management.

Although the macroeconomic and broader structural environment in which financial institutions operate has had an important role in the unfolding of financial crises, the root causes are generally to be found in microeconomic and institutional failings. Generally, problems begin with lax management within financial institutions. Poor internal controls, connected lending, insider dealing, and fraud are often at the origin of poor asset quality. Moral hazard worsens when owners do not face proper incentives to act prudently and to supervise managers, who may then be guided by objectives that are not compatible with sound financial practices and be shielded from external discipline. Weaknesses in the legal framework compound the problems of lax management and weak corporate governance, for instance, by undermining the collection of collateral. Once credit quality has been compromised, regulatory shortcomings and supervisory forbearance can aggravate matters by failing to identify

problems and preventing them from being addressed in a comprehensive and timely fashion. The market can play a crucial role in disciplining bad performers, but this function can be hindered by inadequate information or distorted incentives, such as explicit or implicit government guarantees. In the absence of effective market discipline, the entire burden of external oversight falls on regulators and supervisors, who may not have the requisite capacity.

Key elements of robust financial systems

Crucial actions for strengthening financial systems, whose priority and speed of implementation will vary from country to country depending upon the stage of development of the financial system, are:

- Creation of an institutional setting and financial infrastructure necessary for a sound credit culture and effective market functioning. To this end, it is necessary to:
 - create a legal environment where the terms and conditions of contracts are observed and where legal recourse, including the taking possession of collateral, is possible without undue delay;
 - foster the development and adoption of comprehensive and well-defined accounting principles that command international acceptance and provide accurate and relevant information on financial performance;
 - promote robust payment, settlement and custody arrangements;
 - establish an adequate array of competitive financial markets where a full range of financial instruments can be developed and issued so as to promote financial system resilience and, in particular, facilitate risk management.
- Promotion of the functioning of markets so that owners, directors, investors and other actual and potential stakeholders exercise adequate discipline over financial institutions. To this end, it is necessary to:
 - improve the quality, timeliness and relevance of standards for disclosure of key information needed for credit and investment decisions and foster efficient use of this information by such entities as rating agencies, credit bureaux and central credit registers;
 - promote effective systems of internal management and risk control with strict accountability of owners, directors and senior management (including prevention of insider abuses and financial crime, control of connected lending and promotion of accurate loan valuation, asset classification, risk assessment and provisioning practices);
 - ensure that financial institutions have capital commensurate to the risks they bear, underpinned by the minima established by the relevant international groupings;
 - encourage ownership structures that foster stakeholder oversight, including private ownership to strengthen the monitoring of management performance and to reduce distortions in incentives;

- promote openness and competitiveness in banking and financial markets, subject to essential prudential safeguards;
 - enhance the professionalism and skills of managers of financial systems;
 - design and apply safety net arrangements (deposit insurance, remedial actions, exit policies, etc.) so that the incentives of depositors, investors, shareholders and managers to exercise oversight and to act prudently are not undermined.
- Creation of regulatory and supervisory arrangements that complement and support the operation of market discipline. To this end it is necessary to:
 - ensure that supervisory and regulatory authorities are independent from political interference in the daily execution of supervisory tasks but are accountable in the use of their powers and resources to pursue clearly defined objectives;
 - ensure that the authorities have the power to license institutions, to apply prudential regulations, to conduct consolidated supervision, to obtain and independently verify relevant information and to engage in remedial action;
 - ensure they have the powers and sufficient resources to cooperate and exchange information with other authorities, both at home and abroad, thereby supporting consolidated supervision.

Developing sound principles and practices

A corpus of sound principles and practices is useful when acting to strengthen financial systems. For any specific area or activity relevant for robust financial systems, there should be a single set of principles developed through a broad international consultative process involving national experts with extensive experience in the area in question. The principles developed for various areas should be mutually consistent, and applied in light of the circumstances of each country.

Sound principles and practices should be established in the following areas and by the following international groupings:

Accounting. The International Accounting Standards Committee is working to develop a set of high-quality accounting standards, particularly for listing purposes; if successful it will contribute to ensuring that information contained in the financial statements is accurate, timely and comprehensive. Cooperation with other relevant groupings such as IOSCO and the Basle Committee should continue to take place.

Payments and settlements. The Committee on Payment and Settlement Systems of the G-10 central bank governors should continue to foster the development of efficient, robust payment and settlement systems and practices.

Banking supervision. The Basle Committee on Banking Supervision of the G-10 central bank governors should continue to promote the development of a comprehensive and internationally endorsed set of principles and practices for bank supervision.

Securities market supervision. The members of the International Organisation of Securities Commissions should assign high priority to the development of a

comprehensive and internationally endorsed set of principles and practices for the regulation of securities and futures markets.

Insurance supervision. The International Association of Insurance Supervisors should complete the development of principles relating to the supervision of insurance companies and supplement them by guidelines that could be applied by national authorities.

Financial conglomerates. The three international supervisory groupings (for banking, securities and insurance) should cooperate through the Joint Forum to ensure that conglomerates are subject to adequate supervision, particularly as they present special challenges on account of their size and complexity.

In all areas the work of such groupings should respect the broad strategy and key premises listed above. Where they have not yet done so, the groupings should establish precise time-tables for the completion of their work.

Although the above international groupings should have primary responsibility in their areas of expertise, a complementary role can be played by such other groupings as the Euro-currency standing committee of the G-10 central bank Governors and various committees at the OECD. There are some areas where no single grouping would naturally assume primary responsibility for forging consensus on principles and practices. In these, consideration needs to be given to whether an international consensus on sound practices is needed, and if it is, what procedures should be established for developing one.

Adopting and implementing sound principles and practices

Involving a wide range of countries in the process of formulating principles and practices facilitates their adoption and implementation because it generates a degree of commitment that would be difficult to achieve in the absence of such consultation. A variety of complementary methods contribute to the adoption of sound practices.

Market access

Financial markets can provide strong incentives for the adoption of standards that alleviate creditors' concerns about the soundness of the financial system. The desire to gain access to key financial markets can be a strong incentive as well.

One of the most effective means to spread best practice in banking and other financial activities is through the professional and commercial operations of well-run banks and other institutions active in both established and emerging market economies. Accordingly, authorities in all economies should provide well-managed financial institutions with access to their markets. This will promote the spread of high quality management systems and professional skills, thus contributing to the strengthening of the "credit culture".

International organisations such as the IMF, the World Bank and the regional development banks and the OECD should support this process. They can also contribute to the acceptance and implementation of principles and practices developed by the

relevant international groups. These institutions should foster the spread of best practice through market channels. They should support countries' efforts to reduce the macroeconomic imbalances and eliminate the structural distortions that are at the root of financial instability. By promoting the improvement in the quality and comparability of the information currently made available, and encouraging and supporting further dissemination of data, they can improve the capacity of shareholders, interbank counterparties, retail depositors and other potential and actual claimants to monitor progress and to provide the incentives and discipline that will bolster the robustness of financial systems.

Taking stock of progress in the adoption of sound principles and practices. In its surveillance the IMF should take stock of the progress that countries with clear vulnerabilities have made in the adoption of sound principles and practices developed by the international groupings. In its policy advice it should consider the macroeconomic implications of financial sector or supervisory weaknesses and draw the attention of national authorities to macroeconomic imbalances that can disrupt the banking and financial sector. In some instances, the World Bank may have superior information on financial conditions in a country and on the health of its financial system. The IMF and World Bank should develop modalities for sharing their assessments of financial sector strength and the regulatory and supervisory regimes in individual economies. Other multilateral organisations with less universal membership can also contribute to monitoring the adoption of sound practices. The OECD engages in peer group reviews in this area, and the European Commission considers the strength of the financial sector in the process of accession.

Advice for financial sector reform. The World Bank and the regional development banks are the most appropriate institutions for providing advice for the development of robust, efficient financial structures in emerging markets. This will involve the provision of advice to client countries modelled on the norms developed by the international groupings.

Financing programmes of financial sector reform. The World Bank and the regional development banks should provide financing for financial sector reform and structural measures to strengthen financial systems. In cases where immediate balance of payments problems or macroeconomic strains arise in part because of weakness in the financial sector or in the framework for financial supervision and regulation, IMF supported programmes could include steps to correct shortcomings in the financial sector.

Technical assistance can be of great help in developing the skills needed for a robust financial system. Such assistance can be provided by the private sector, by the bilateral official sector and by the multilateral agencies. The private sector and bilateral official sector both have expertise and experience that is highly relevant and are therefore in a good position to support countries' efforts to strengthen their financial systems. The multilateral institutions should foster the spread of this expertise as they give higher priority to financial sector issues in their activities. Among the multilateral institutions the World Bank and the regional development banks should play a leading role in providing technical assistance to countries seeking to build strong financial systems. Coordination is needed to ensure that activities of the different institutions are

complementary. The recipient countries should play an active role in coordinating the technical assistance they receive so as to ensure that it addresses their needs.

Coordination. Because the roles and responsibilities of the Fund and the Bank overlap in many respects, close coordination between them is essential with respect to their assessment of financial systems, programme design and technical assistance. They should also further clarify their respective roles in order to ensure complementarity, bearing in mind their different comparative advantages. In all three areas they should develop practical and effective means to ensure close collaboration. It is also important to ensure that there is adequate cooperation between the Bretton Woods institutions and other multilateral institutions, such as the regional development banks, European Commission and the OECD and also with the international groupings such as the Basle Committee and IOSCO. The Bretton Woods institutions should work in close cooperation with the international groupings that have developed norms and principles relevant for financial stability. The multilateral institutions should utilise the prevailing norms when developing internal guidelines for use by their country and sector experts. In addition, they should cooperate with various international groupings, exchanging relevant information as needed.

International Bank for Reconstruction and Development

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SecM97-328

FROM: The Acting Secretary

April 27, 1997

**Joint Statement by the President of the World Bank
and the Managing Director of the IMF on
Collaboration in Strengthening Financial Sectors**

Attached for the information of Executive Directors is the Joint Statement by the President of the World Bank and the Managing Director of the IMF on "Collaboration in Strengthening Financial Sectors". This statement is being circulated to the IMF Executive Directors.

Distribution:

Executive Directors and Alternates
President's Executive Committee
Senior Management, Bank, IFC and MIGA
Secretary, IMF

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

**Joint Statement By the Managing Director of the IMF and the President of the
World Bank on Collaboration in Strengthening Financial Sectors**

1. We have become increasingly concerned that problems in the financial sector and especially the banking system, which have been widespread in recent years, are disruptive to growth and macroeconomic stability, and can spill over regionally and internationally. In response to these growing concerns, and to calls from the international community for greater attention by international financial institutions to financial sector issues, the International Monetary Fund (IMF) and the World Bank Group (WBG) are increasing their efforts to assist members in maintaining sound financial systems. As part of this strengthened effort, we are working intensively to develop a framework for cooperation in our financial sector activities that clarifies the division of responsibilities and strengthens the procedures for collaboration between the two institutions. The following outlines the main elements of this framework for collaboration.
2. The roles of the two institutions in the financial sector will continue to be guided by their mandates and by the principles for cooperation set out in the 1989 Joint Memorandum on Bank-Fund Collaboration in Assisting Member Countries. Accordingly, the IMF's involvement in all its member countries will relate primarily to the macroeconomic aspects of financial systems and markets; the WBG's role will primarily concern the sectoral and developmental aspects of financial systems in developing countries.
3. The IMF has a mandate to oversee the international monetary system in order to ensure its effective operation, and to oversee members' economic performance and policies, in particular their efforts to promote stability by fostering orderly underlying economic and financial conditions and a sound monetary system. Since problems in financial systems can have national and international macroeconomic repercussions, increased attention is being paid in both bilateral and multilateral surveillance to banking and broader financial sector issues. In so doing, the IMF will, inter alia, promote the adoption and implementation in member countries of frameworks for sound financial systems that are consistent with internationally accepted standards, as developed by the supervisory community and other bodies, and assess members' progress in this regard where it is deemed necessary. IMF surveillance will draw on the expertise of a range of other institutions, including the BIS and the Basle Committee, as well as the assessments of the WBG in those countries where the Bank is involved.
4. Because a sound financial sector is a critical component of a sustainable development program, the Bank often carries out assessments of the health and performance of the financial sector in client countries through its economic and sector work. In addition, the financial intermediation lending program of the Bank, as well as programs related to privatization and infrastructure financing, often provide the Bank with an assessment of the condition of individual financial intermediaries and the financial infrastructure in client

countries. Bank assessments typically have a longer-term developmental perspective, and a more structural orientation than financial sector analysis by the Fund.

5. Technical assistance on financial sector issues will continue to be provided by both the IMF and the WBG. An important responsibility of the World Bank will be to provide advice and support to developing countries seeking to build strong financial systems. The technical assistance provided by the Bank will include financial institution and market infrastructure development, and financial sector policy, law, regulation and supervision. Consistent with its macroeconomic focus and in support of its surveillance and lending activities, IMF technical assistance will relate to the general area of central banking operations and monetary management, including the instruments and institutions of monetary policy making, prudential supervision and banking legislation. In providing technical advice on supervisory and regulatory practices in relation to financial institutions and markets, the Bank and the Fund will adhere to established international standards.

6. Lending operations are another activity where closer coordination is being pursued. The WBG makes loans specifically designed to promote financial sector soundness. These operations include lending in support of broad-based structural and institutional reforms, and in support of the development of institutional and human resource capacity. The IMF provides financial assistance in support of broad macroeconomic adjustment programs. These programs may include policy conditions related to financial sector reforms where those reforms are important for macroeconomic performance. In areas of the WBG's primary responsibility, such as financial sector restructuring, those conditions would normally be based on the Bank's policy recommendations. Coordination between the two institutions will aim at ensuring early involvement of each institution in its areas of primary responsibility, and full consistency between the IMF's macroeconomic analysis and the WBG's sectoral policy recommendations.

7. As clearly indicated above, there will be instances where the two institutions are acting together and where overlap in our operations could potentially arise. Enhanced coordination and information sharing will therefore be essential to the effective strengthening of our joint efforts to help improve the soundness of financial systems. The necessary collaboration will be pursued through the intensification of cooperation through existing channels, including the frequent routine contacts between the IMF and WBG staffs and managements, and through new mechanisms that will be established. Procedures for collaboration in financial sector activities between the WBG and the IMF, including the division of responsibilities outlined above, are being further developed and refined, and a more detailed framework for cooperation in this area will be presented to the Executive Boards of the two institutions in the near future.

CEPS Symposium: Princeton, May 2-3, 1997
"Opportunities and Risks in Emerging Markets"

Friday, May 2: McCosh 50, Princeton University

5:00 p.m. Public Keynote Address by **James Wolfensohn**, President, The World Bank
(Part of 250th Anniversary Celebration)

6:30 p.m. Cocktails and Q&A session with James Wolfensohn (6:30 p.m. to 7:00 p.m.) and
dinner (7:30 p.m.) at Prospect House. CEPS Members and Symposium
Participants Only.

Saturday, May 3: Bowen Auditorium, Bowen Hall, Princeton University

9:00 a.m. ***Sources of Opportunity, Sources of Risk***
Charles Clough, Chief Investment Strategist, Merrill Lynch
David Hale, Managing Director, Kemper Financial Services

10:15 a.m. Break

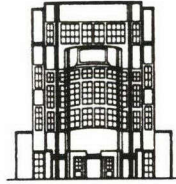
10:30 a.m. ***Members Forum: Experiences in Emerging Markets***
James Cullen, Vice Chairman, Bell Atlantic
Nancy Newcomb, Customer Group Exec., Global Relationship Banking, Citibank
George Suter, VP, International, Consumer Health Care, Pfizer Inc

12:00 p.m. Lunch

1:30 p.m. ***Regional Outlooks -- China, Former Soviet Union, and Latin America***
Austin Beutner, Vice Chairman, The U.S. - Russia Investment Fund
Nelson An-ping Chang, President, Chia Hsin Cement Corporation
Suhas Ketkar, Director and co-head of Global Emerging Markets Economics,
Credit Suisse First Boston

2:45 p.m. ***Portfolio Investment Strategies***
Burton Malkiel, Princeton University

4:00 p.m. Adjourn



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Jane Kadda
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March 11, 1997

Mr. James Wolfensohn
President
The World Bank
Washington, DC 20433

Dear Mr. Wolfensohn:

Thank you once again for agreeing to participate as the keynote speaker in the upcoming CEPS symposium on May 2-3, 1997. As you can see from the enclosed program, we expect a very stimulating and informative symposium.

The program begins with your public keynote address at 5:00 p.m. on Friday, May 2, in McCosh 50. Your lecture will be immediately followed by a private dinner for CEPS members and symposium participants at Prospect House, on the campus. The Saturday sessions, including lunch, will be held in Bowen Hall. (See enclosed map.)

~~Please fill out and return the enclosed reply form to let us know how we can help with your travel and lodging arrangements and any special requirements that you might have, including the need for audio-visual equipment.~~

Speakers will stay at the Nassau Inn, and CEPS will be billed directly for all lodging charges. We ask that you make your own travel arrangements, however, and submit your receipts to me for prompt reimbursement. Once you know your travel plans, we will also be happy to arrange ground transportation for you to and from the airport or Trenton train station.

Finally, could you please send us a short bio for use in our conference folder, and any written materials that you would like distributed to attendees?



If you have any questions, please do not hesitate to call. We look forward to seeing you here in Princeton.

Yours truly,


Susan B. Simonelli
Assistant Director
(609) 258-5765

Encls.

cc: Alan Blinder
Harvey Rosen

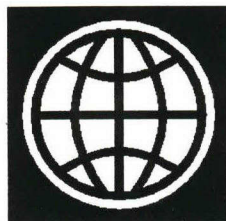
Alan Blinder
10-30-80
Q+A

CEPS Dinner
Friday, May 2, 1997

John & Raluca Allison	W.P. Stewart & Co., Inc.
Jack & Phoebe Ballard	Princeton Class of '50
Alan & Madeline Blinder	Princeton University
Beth Bogan	Princeton University
William & Sandy Bond	Jacksonville, FL
David Bradford	Princeton University
William Branson	Princeton University
Sebastian Calabro	Commodities Corporation (USA)
Nelson An-ping Chang	Chia Hsin Cement Corporation
Gregory & Paula Chow	Princeton University
Charles Clough	Merrill Lynch
Dana Cogwell	Merrill Lynch
Philip Collins	Hopewell, NJ
Joseph Connolly	Citibank
Robert Cronheim	Princeton Class of '50
Jim Dunigan	PNC Bank
Phyllis Durepos & Nick Fafalios	Princeton University
Robert Easton	Commodities Corporation (USA)
Joseph Fichera	New York, NY
Arminio Fraga	Soros Fund Management
David Goldsmith	Grand Street Boys' Foundation
Rudolph Gonzalez	Princeton University
Christopher Graja	Bloomberg Magazine
James Gramlich	Pennington, NJ
David Hale	Kemper Financial Services
Bill Hester	Bloomberg Magazine
Sam Jaffe	Bloomberg Magazine
Jack & Joan Hall	Johnson & Johnson
Alison Keith	Pfizer Inc
Peter & Reggie Kenen	Princeton University (maybe)
Karen Mair	Merrill Lynch
Burton & Nancy Malkiel	Princeton University (?)
Robert & Sara Matthews	Princeton University
David & Sally McAlpin	Princeton Class of '50
Jianping Mei	New York University
Tom Melcher	PNC Bank
Arun Motianey	Citicorp Center
Nancy Newcomb	Citibank
John O'Hara	Commodities Corporation (USA)
Beth Protage	PNC Bank
Henry Rentschler	Princeton Class of '50
Charles & Solange Rose	Princeton Class of '50
Harvey Rosen & Marsha Novick	Princeton University
Jacob Rosengarten	Commodities Corporation (USA)
Antranig & Varsenne Sarkissian	Citicorp
Susan Simonelli	Princeton University
Austin Starkey	PNC Bank
Menachem & Liora Sternberg	Caxton Corporation
John & Pam Torkelsen	Princeton Venture Research, Inc.
Frank & Barbara Vannerson	Little Brook Corporation

New Jersey

***The World Bank
&
New Jersey:
Partners in Development***



What is the World Bank?

The World Bank Group is a partner in strengthening economies and expanding markets to improve the quality of life for people everywhere, especially in the poorest countries, which lack the ability to obtain development financing from other sources. A first-rate financial standing and access to the world's capital markets enable the Bank to invest broadly in societies -- from investments in health, education, and the environment, to infrastructure and policy reform. The World Bank's near-universal membership gives it global reach. In working with its members, the World Bank builds on its financial role by mobilizing resources other than its own -- especially private capital -- and offering research and policy advice. The World Bank distills and disseminates its cross-country experience and helps connect clients with the world's best development knowledge base.

The World Bank continually adapts its products and services to meet the changing needs of its global membership. Over its 50-year life, the World Bank has lent well over \$300 billion for more than 6,000 development operations in more than 140 countries. The diversity of its work is reflected in the nature of the Group. **The World Bank Group is...**

The International Bank for Reconstruction and Development (IBRD). The biggest affiliate of the World Bank Group, the IBRD is owned by and is accountable to its 179 member countries. Each country has shares and votes in proportion to its size in the world economy. The United States is the biggest shareholder and has 17 percent of the votes. The IBRD makes loans to middle-income developing countries at near-market rates. The IBRD is also profitable, conservatively managed, and cost-effective. It has an administrative expenses-to-assets ratio well below that of commercial banks. The IBRD finances its operations mainly by borrowing on capital markets on the most favorable terms and passing the savings on to developing-country members. Investors in IBRD bonds similarly benefit from its strength and efficiency. Countries with 1992 per capita incomes of over \$4,715 are expected to begin the IBRD graduation process.

The International Development Association (IDA). While the IBRD lends to countries able to pay market rates, IDA lends on concessional terms to the poorest countries -- often those with individual incomes of less than a dollar a day. These countries usually lack access to development financing from any other source. Countries graduate from IDA to IBRD when their income exceeds the eligibility threshold, currently a 1992 per capita income of less than \$1,305. IDA is funded primarily by government contributions from its richer member countries.

The International Finance Corporation (IFC). The World Bank Group's private sector arm, IFC invests directly in private enterprise in developing countries. IFC invests \$2.5 billion a year, making it the largest source of multilateral equity and loan financing for private sector projects in the developing world.

The Multilateral Investment Guarantee Agency (MIGA). MIGA offers insurance against non-commercial risks to foreign private investors in developing countries and investment marketing services to developing countries attempting to attract foreign investment.

How The World Bank is Working for You

Since its founding in 1946, the World Bank Group has worked to strengthen economies and expand markets, to the benefit of both developed and developing countries. Consisting of a group of strong economic institutions, the World Bank Group continues to bring significant economic opportunities to all the United States. Here are some examples of how the Bank has financed projects and helped to open markets for New Jersey in recent years:

- Exports from New Jersey to **China** rose 425% (\$280 million) between 1990 and 1995, enabling it to become New Jersey's 11th largest market worldwide.
- New Jersey's exports to **Brazil** rose 191% since 1990 to total \$416 million in 1995, making it New Jersey's 9th largest market that year.
- Three of the top 15 markets for New Jersey's biggest industry in 1995, chemicals and allied products, were developing countries. New Jersey's exports of these products to **Mexico** rose 45% since 1990, totaling \$181 million and representing 5% of the industry's total in 1995.
- Exports from New Jersey to **the Republic of Korea**, an IDA and IBRD graduate, totaled \$530 million in 1995, enabling that developing country to become New Jersey's 6th largest export market.
- In 1995, a branch of the consulting company **Louis Berger International** in East Orange, received an \$8.6 million IDA-financed contract to design and supervise a project to rehabilitate the main north-south highway in Viet Nam.
- Clinton-based **Foster Wheeler Energy Corp.**, an engineering construction company, received a \$157.1 million IBRD-financed contract in 1993 to provide boilers for a thermal power plant in Zouxian, China.
- **American Cynamid Company**, of Wayne, received a \$7 million MIGA guarantee in 1994 against the risk of expropriation for its investment in a facility to produce and distribute pharmaceuticals in China.

These are only a few examples of how the World Bank is helping to open markets and expand opportunities for business. As you will see in this pamphlet, multilateral development banks like the World Bank help make developing countries the fastest growing export markets for U.S. goods and services.

Developing Countries, Developing Markets...

Exports from the United States to developing countries increased from \$91 billion in 1987 to more than **\$191 billion** in 1995, accounting for more than **33%** of total U.S. exports in that year alone

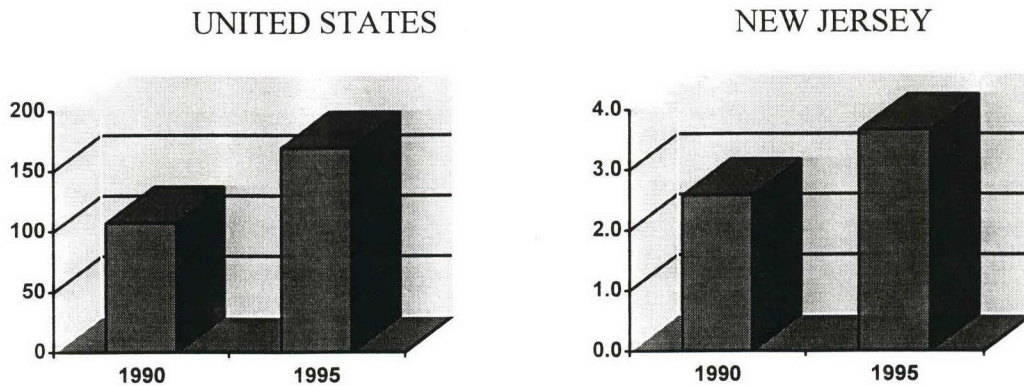
Why? Roughly 5 billion people now live in market-oriented economies, compared to just 1 billion a decade ago, as nations that used to be part of the “Third World” are transforming themselves into market-oriented economies and attracting global investment. During the first three years of this decade, developing countries accounted for **70%** of the growth in global GDP and **half** the growth in world trade.

In partnership with its member countries and other multilateral development banks (MDBs), the World Bank has helped promote this growth by encouraging economic and social progress in developing nations, and by helping raise productivity so that people may live better and fuller lives. To reach these goals, the World Bank has combined financial support with sound economic advice, encouraging trade liberalization and the removal of institutional impediments and policy restrictions to economic growth. Combined with the strong efforts of developing countries, these policies have served to markedly improve living standards in the poorest countries in the world. At the same time, these policies are creating opportunities for businesses in many of the richest countries in the world.

Latin America is a prime example. In the late 1980s, the World Bank and the Inter-American Development Bank, among other institutions, began to support strongly the reform efforts being made by the governments in the region. Over six years, the two banks lent over \$60 billion to the region and encouraged trade policy reform. In 1995, following the Mexican peso crisis, the Bank lent \$1.5 billion to Mexico and \$500 million to Argentina to reform their banking sectors. The assistance and reforms have been working. Latin America is now the fastest growing market for U.S. exports, and New Jersey's exports to the region totaled **\$1.75 billion** in 1995, rising **41%** since 1990.

Simply put, the World Bank is helping to develop markets. According to the U.S. Treasury, between 1981 and 1992 in 75 countries where the World Bank supported pro-market trade reforms, U.S. exports rose by an annual rate of 11.8%, compared to 3.7% in other countries. The U.S. Treasury also reports that “Additional U.S. exports of some \$5 billion annually result from MDB-supported policy reforms and programs which reduce trade and investment barriers in developing countries and expand their import capacity.” Furthermore, current borrowers of the International Development Association (IDA) bought over \$25 billion of U.S. exports in 1995. All in all, according to the U.S. Treasury, the sales to markets with which the MDBs are working in partnership “are responsible for creating or sustaining nearly 4 million U.S. jobs each year.” As Jessica Matthews, a senior fellow on the Council on Foreign Relations, sums up, “Though the [multilateral development] banks' business is to promote growth in developing countries, not to make us richer, they have been notably successful at both.”

Exports to Developing Countries, 1990-95
(billions of U.S. dollars)



Source: Massachusetts Institute for Social and Economic Research

Exports to developing countries from both the U.S. and New Jersey are booming, rising in 1995 to about \$191 billion and \$3.9 billion, respectively.

The Top 10 Developing-Country Markets for U.S. Exports, 1990-95
(billions of U.S. dollars)

Country	1990	1995	% Increase 1990-95	\$ Value Change 1990-95
Mexico	28.4	46.3	63.2	17.9
Rep. of Korea	14.4	25.4	76.5	11.0
China	4.8	11.7	144.4	6.9
Brazil	5.1	11.4	126.1	6.3
Malaysia	3.4	8.8	157.5	5.4
Thailand	3.0	6.4	114.0	3.4
Saudi Arabia	4.0	6.1	50.8	2.1
Venezuela	3.1	4.6	49.4	1.5
Colombia	2.0	4.6	127.1	2.6
Argentina	1.2	4.2	255.3	3.0

Source: Massachusetts Institute for Social and Economic Research

All of these countries are important markets for New Jersey, with 6 of them among the state's top 25 export markets in 1995 (see chart on page 8).

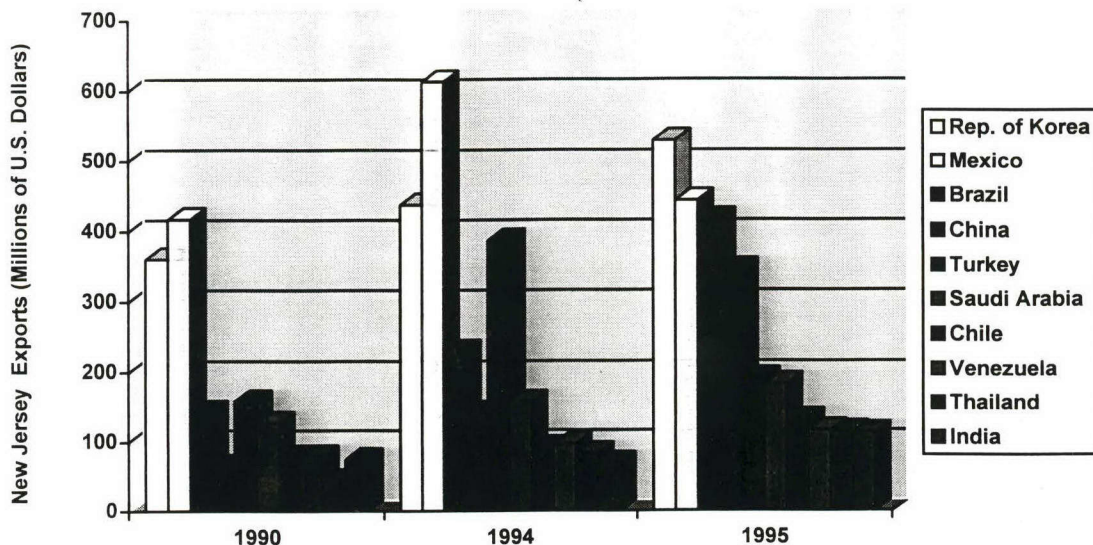
... and Developing New Jersey

The New Jersey business community is taking advantage of opportunities in emerging markets, and the state is reaping the benefits. In 1995, 8 of New Jersey's top 25 export markets were developing countries, and, since 1990, New Jersey's exports to those 8 countries grew 65%. New Jersey's export growth to developing countries in general from 1990 to 1995 was 51%, bringing **an additional \$1.3 billion to New Jersey's economy**. According to the U.S. Government, this creates an **additional 26,000 jobs for New Jersey**.

The greatest percentage export growth for New Jersey has been in the Middle East and North Africa, to which New Jersey exports rose 101% between 1990 and 1995 (an increase of \$541 million). Exports to the state's second largest market in the region, Saudi Arabia, had risen 44% since 1990, to total \$183 million in 1995. New Jersey exports to other developing countries in the region showed tremendous growth between 1990 and 1995 as well, with exports to Lebanon, Jordan and Syria all rising over 280%. New Jersey's exports are also rising rapidly to East Asia and the Pacific, to which exports rose 43% (\$923 million) between 1990 and 1995. Exports to the Republic of Korea, the state's second largest market in the region, rose 47% since 1990 to total \$530 million in 1995, and exports to China rose 425% in the same time period, to \$346 million. These two regions, as well Latin America and the Caribbean (to which New Jersey's exports rose 41%, \$504 million, in this time), should continue as booming markets for New Jersey's goods.

A Country-by-Country Look

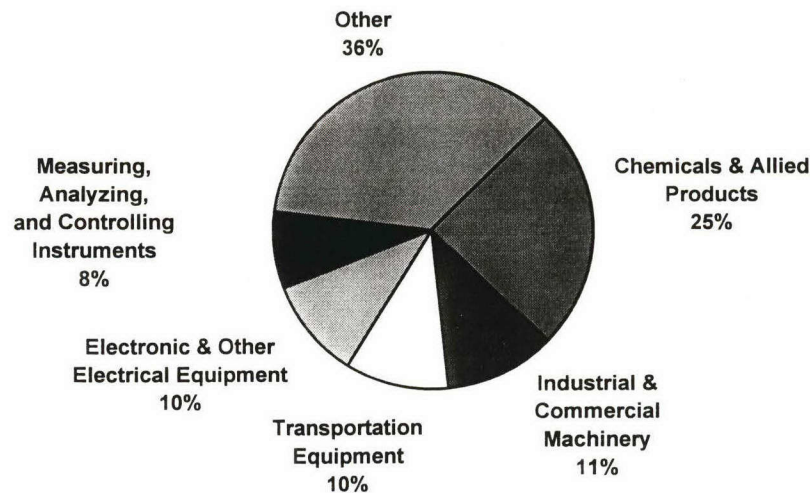
The Top 10 Developing-Country Export Markets for New Jersey Goods



Source: Massachusetts Institute for Social and Economic Research

New Jersey's Top 5 Industries are Expanding

New Jersey is sending developing countries a wide variety of its high-quality products. Following is a chart of New Jersey's top 5 export industries and the share of the state's total exports (\$13.8 billion) they accounted for in 1995. Also included are examples of how these industries are being helped by increased trade with markets the World Bank is working to open:



Source: Massachusetts Institute for Social and Economic Research

- **Chemicals and Allied Products (\$3.4 billion of New Jersey's exports in 1995)**
Three of the top 15 markets for New Jersey's machinery exports in 1995 were developing countries (Mexico, the Republic of Korea, and Brazil). New Jersey chemicals exports to these countries rose an average of 52% since 1990, to total \$364 million.
- **Industrial and Commercial Machinery (\$1.5 billion)**
In 1995, 7 of New Jersey's top 21 markets for this machinery were developing countries. New Jersey's machinery exports to the Republic of Korea, the second largest market for this New Jersey equipment, rose 110% since 1990, totaling \$120 million and representing 8% of the market in 1995.
- **Transportation Equipment (\$1.5 billion)**
New Jersey's exports of this equipment to Brazil rose an astounding 17,833% since 1990, to total \$147 million in 1995. This enabled Brazil to become New Jersey's third largest market for this industry, representing 10% of total exports of transportation equipment.
- **Electronic and Other Electrical Equipment (\$1.4 billion)**
Exports of this equipment to China totaled \$165 million in 1995, having risen 11,602% since 1990. This enabled China to become New Jersey's second largest market for this equipment, representing 11% of the industry total.
- **Measuring, Analyzing, and Controlling Instruments (\$1.1 billion)**
Exports of these New Jersey instruments to the Republic of Korea, Brazil and Mexico represented 9% of New Jersey's industry total of \$94 million.

New Jersey's Top 25 Export Markets, 1995

Eight of New Jersey's top 25 markets in 1995 were developing countries: one is a current IDA borrower, two are IDA graduates eligible for IBRD loans, and one is both an IDA and IBRD graduate. It is interesting to note that exports to 6 developed countries actually decreased between 1990 and 1995.

Country Name	Exports in 1990	Exports in 1995	% Change 1990-95	\$ Value Change 1990-95	% of 1995 NJ Total
CANADA	\$2,371,423,162	\$3,294,781,673	38.94%	\$923,358,511	23.82%
JAPAN	\$732,634,827	\$891,681,438	21.71%	\$159,046,611	6.45%
UNITED KINGDOM	\$639,058,271	\$819,207,945	28.19%	\$180,149,674	5.92%
FED. REP. OF GERMANY	\$528,453,383	\$744,037,274	40.80%	\$215,583,891	5.38%
ISRAEL	\$270,384,308	\$678,326,244	150.87%	\$407,941,936	4.90%
❖ REP. OF KOREA	\$360,774,531	\$529,984,192	46.90%	\$169,209,661	3.83%
NETHERLANDS	\$482,159,999	\$466,672,389	-3.21%	(\$15,487,610)	3.37%
MEXICO	\$417,009,207	\$442,701,655	6.16%	\$25,692,448	3.20%
BRAZIL	\$142,777,444	\$415,814,407	191.23%	\$273,036,963	3.01%
FRANCE	\$307,042,393	\$383,735,187	24.98%	\$76,692,794	2.77%
*CHINA (MAINLAND)	\$65,955,115	\$346,194,992	424.89%	\$280,239,877	2.50%
SWITZERLAND	\$196,383,174	\$320,698,085	63.30%	\$124,314,911	2.32%
BELGIUM	\$370,980,896	\$313,145,459	-15.59%	(\$57,835,437)	2.26%
CHINA (TAIWAN)	\$310,745,228	\$260,963,443	-16.02%	(\$49,781,785)	1.89%
HONG KONG	\$132,944,634	\$255,720,705	92.35%	\$122,776,071	1.85%
AUSTRALIA	\$181,091,423	\$255,586,670	41.14%	\$74,495,247	1.85%
ITALY	\$258,617,883	\$232,722,439	-10.01%	(\$25,895,444)	1.68%
**TURKEY	\$157,943,644	\$191,415,891	21.19%	\$33,472,247	1.38%
SAUDI ARABIA	\$126,902,462	\$183,173,288	44.34%	\$56,270,826	1.32%
SINGAPORE	\$121,677,833	\$165,908,591	36.35%	\$44,230,758	1.20%
SPAIN	\$177,781,279	\$155,979,839	-12.26%	(\$21,801,440)	1.13%
SWEDEN	\$90,712,200	\$141,582,115	56.08%	\$50,869,915	1.02%
IRELAND	\$210,837,636	\$134,798,761	-36.07%	(\$76,038,875)	0.97%
**CHILE	\$78,717,191	\$130,887,994	66.28%	\$52,170,803	0.95%
VENEZUELA	\$78,805,391	\$116,069,716	47.29%	\$37,264,325	0.84%
Top 25 Total	\$8,811,813,514	\$11,871,790,392	34.73%	\$3,059,976,878	85.82%
Total Developed	\$7,673,040,727	\$9,938,148,693	29.52%	\$2,265,107,966	71.84%
Total Developing	\$2,582,745,108	\$3,894,823,765	50.80%	\$1,312,078,657	28.16%
New Jersey Total	\$10,255,785,835	\$13,832,972,458	34.88%	\$3,577,186,623	100.00%

❖ IDA and IBRD Graduate - 1

**IDA Graduates eligible for IBRD loans - 2

*Current IDA Borrowers - 1

Note: Shaded areas are developing countries.

Source: Massachusetts Institute for Social and Economic Research

25 Markets Posting the Largest Percentage Increase in New Jersey's Exports, 1990-95

Of the 25 markets to which New Jersey's exports rose the most between 1990 and 1995, 19 are developing countries. New Jersey's exports to those countries grew 221% in that period and totaled \$1.3 billion in 1995.

Country Name	Exports in 1990	Exports in 1995	% Change 1990-95	\$ Value Change 1990-95
MACAU	\$26,275	\$3,630,864	13718.70	\$3,604,589
*VIETNAM	\$31,776	\$4,131,821	12902.96	\$4,100,045
**SYRIA	\$665,291	\$6,047,580	809.01	\$5,382,289
CAYMAN ISLANDS	\$800,551	\$4,623,550	477.55	\$3,822,999
*CHINA	\$65,955,115	\$346,194,992	424.89	\$280,239,877
POLAND	\$7,405,309	\$34,406,657	364.62	\$27,001,348
**JORDAN	\$2,828,323	\$11,421,727	303.83	\$8,593,404
NORWAY	\$17,193,783	\$68,986,407	301.23	\$51,792,624
LEBANON	\$4,484,738	\$17,084,569	280.95	\$12,599,831
URUGUAY	\$4,670,344	\$15,347,980	228.63	\$10,677,636
QATAR	\$1,823,457	\$5,671,182	211.01	\$3,847,725
**DOMINICAN REPUBLIC	\$28,280,084	\$83,875,683	196.59	\$55,595,599
CYPRUS	\$1,782,158	\$5,234,683	193.73	\$3,452,525
BRAZIL	\$142,777,444	\$415,814,407	191.23	\$273,036,963
**EL SALVADOR	\$9,567,454	\$25,841,524	170.10	\$16,274,070
UNITED ARAB EMIRATES	\$23,532,003	\$62,637,826	166.18	\$39,105,823
*GHANA	\$1,303,336	\$3,323,211	154.98	\$2,019,875
**THAILAND	\$44,752,792	\$113,846,180	154.39	\$69,093,388
ISRAEL	\$270,384,308	\$678,326,244	150.87	\$407,941,936
KUWAIT	\$22,477,168	\$55,277,862	145.93	\$32,800,694
ROMANIA	\$2,897,885	\$7,021,833	142.31	\$4,123,948
BAHRAIN	\$2,847,978	\$6,544,438	129.79	\$3,696,460
**PARAGUAY	\$2,655,945	\$6,042,264	127.50	\$3,386,319
**COLOMBIA	\$47,313,927	\$105,209,871	122.37	\$57,895,944
**COSTA RICA	\$24,390,942	\$53,141,605	117.87	\$28,750,663

**IDA graduates eligible for IBRD loans - 8

*Current IDA Borrowers - 3

Note: Shaded areas are developing countries.

Countries with 1995 export \$ value of less than \$2.5 million have been excluded from this list.

Source: Massachusetts Institute for Social and Economic Research

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— Senior U.S. Treasury Official



The World Bank is helping developing countries, and that is helping New Jersey's businesses. For more information about the World Bank, its programs, and how you can capitalize on trade and investment opportunities in developing countries, please contact:

***John Donaldson
External Affairs
The World Bank
1818 H Street, NW
Washington, DC 20433
202-473-1367***

Document sources: Massachusetts Institute for Social and Economic Research, the United States Department of Commerce, the United States Department of Treasury, and the World Bank.

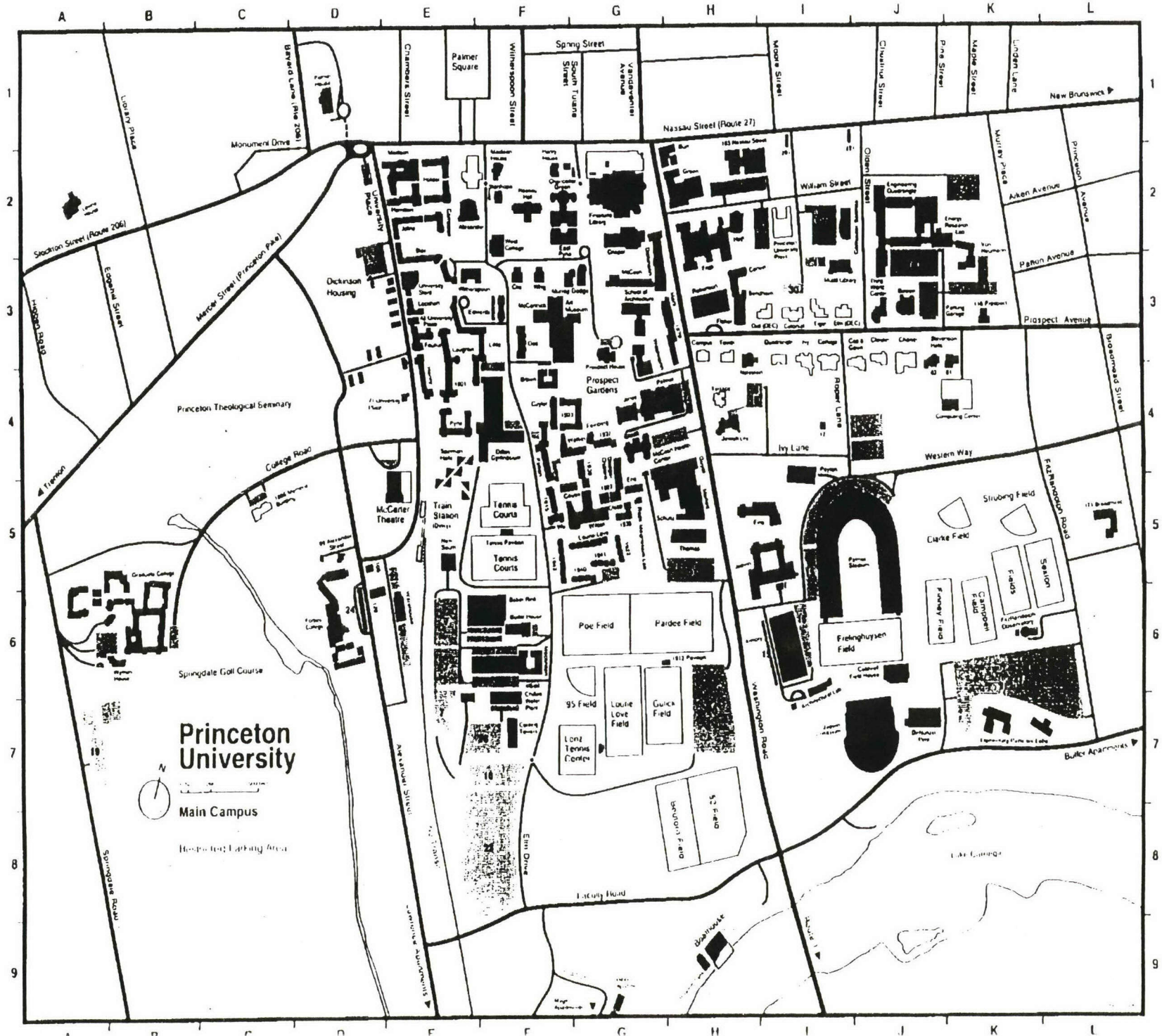
Bowen Hall = J3

McCosh = G3

Parking Lot 10/10A = H2

Parking Garage = J3

Prospect House = G3



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